

China's Bank Non-Performing Loan Problem: Seriousness and Causes

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I. Introduction

A comprehensive understanding of the bank non-performing loan (NPL) problem is a prerequisite for any policy recommendations on NPL workout and prevention. This paper shows the seriousness of the NPL problem in China and analyzes its causes. Section II refers to different estimates of the total amount of China's NPLs and describes their negative effects on state banks, the entire banking system, economic reform, and real economic growth. In Section III, a theoretical framework is established—that the deterioration of market discipline is the ultimate cause of the NPL problem in China, followed by empirical analyses in Section IV. Market discipline failed in China due to the dominating role of state banks in China's financial markets, soft credit to state-owned enterprises (SOEs) by state banks, unnecessary administrative control of banks (credit plan and interest rate control), weak internal control systems within banks, and inappropriate banking regulations. The failure of these conditions led to the failure of market discipline of SOEs and state banks and, consequently, to ruthless lending and borrowing activities, resulting in accumulated NPLs on state bank balance sheets. Some policy recommendations on NPL workout and prevention are made in Section V.

II. The Seriousness of the NPL Problem in China

A. THE LARGE NUMBER OF EXISTING NPLS AND INCREASING NUMBER OF NEW NPLS

The seriousness of China's NPL problem can hardly be exaggerated. Chinese scholars estimate that the proportion of NPLs to bank assets have varied from 10 percent to 40 percent.¹

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1. Different estimates of the proportion of NPLs to total state commercial banks' assets can be found in the following publications—ten percent: *POLICIES AND PROCEDURES FOR ASSET RESTRUCTURING* 31 (Yue Pan ed., 1997); twenty percent: PBOC Policy Study Office, *Issues on Bank and Enterprise Debt Restructuring* (1995); 22.3%:

Two reasons contribute to the various estimations of scholars: one is that different asset classification standards were applied; the other is that most of the estimation was based on samples rather than on statistics. What can be said without doubt is that the huge amount of bad assets accumulated within [state] banks may have very serious consequences and must be paid close attention to.²

The ratio of NPLs to total outstanding loans at the big four state commercial banks³ was officially recognized to be 25 percent in 1999.⁴ Some foreign observers believe, however, the ratios are much higher. According to Goldman Sachs, for example, a more stringent and internationally accepted classification would show that the mainland's banking sector had one of the highest NPL levels in Asia, ranging from thirty to 60 percent.⁵

In addition, despite large write-offs in recent years,⁶ NPL levels have been rising steadily in China.⁷ It was estimated that new NPLs are being increasingly created on state banks' books at an annual rate of 2 percent.⁸ The situation in some areas is even worse.⁹ A People's Bank of China (PBOC) report released on April 16, 1999, stated that NPLs rose sharply

Gang Yi, *The Asset Structure of China's Financial Institutions and Its Policy Implication*, JINGJI YANJIU No. 12 (1996); twenty to thirty percent: Yuncheng Huang, *Bank Reform and Debt Restructuring*, BEIJING: GUANLI SHIJE No. 6 (1996); thirty percent: Jingyong Xv, *Causes to the Deterioration of the Asset Quality of State Specialized Banks*, DANGDAI JINGJI YANJIU No. 1 (1996); twenty-five to forty percent: Xianxiang Lu, *Problems with the Three Lending Models of China's Commercial Banks*, GUOJI JINGRONG YANJIU No. 12 (1996).

2. Qi-jiang Qing, Address at the International Seminar on Bank and Enterprise Debt Restructuring (transcript available in the PBOC Policy Study Office).

3. The big four are the Industrial and Commercial Bank of China (ICBC), China's Construction Bank (CCB), the Agricultural Bank of China (ABC), and the Bank of China (BOC).

4. The total figure for NPLs includes those that were overdue for less than one year and might be recovered. There is also a core of bad and doubtful loans that would have to be written off. These amounted to between seven and ten percent of total lending. See, e.g., Peter Montagnon & James Harding, *China to Cut Number of Non-performing Loans*, FIN. TIMES (London), Sept. 13, 1999, at Asia-Pac. 6. The twenty-five percent ratio rose from the twenty percent estimation in 1996: the PBOC governor Dai Xianglong said then that eight percent of outstanding loans at state banks were more than three years overdue and another twelve percent were less than three years overdue. See, e.g., Seth Faison, *China Asserts It Curbs Inflation but Not Robust Growth*, N.Y. TIMES, July 16, 1996, at D3.

5. The outstanding loans amounted to RMB 9.6 trillion as of March 31, 1999, 110% of the GDP this year. Xiangwei Wang, *Goldman Puts Loan Clean-up Bill at U.S.\$272 Billion*, S. CHINA MORNING POST, Sept. 24, 1999, at 4.

6. It is reported that China wrote off RMB 30 billion (U.S.\$3.62 billion) in bad debts in 1997 and RMB 40 billion (U.S.\$4.83 billion) in 1998. See *China Wrote Off U.S.\$3.62 Billion in Bad Debts in 1997, U.S.\$4.83 Billion in 1998*, at http://www.chinaonline.com/top_stories/breakingnews_c9022405.html. These two years write-offs were based on a RMB 23.8 billion write-off in 1996. See PBOC, CHINA FINANCIAL OUTLOOK 1998, 20 (1998).

7. China's banking sector has been increasing loans to inefficient SOEs at a rate that outstrips output growth, thereby heaping new NPLs on old ones. See, e.g., James Harding, *China: Market Differences Emphasized*, FIN. TIMES (London), Jan. 28, 1999.

8. An article based on an interview with Dai Xianglong, then vice-governor of the central bank, states that the proportion of NPLs of China's large state-owned banks "has been rising by two percentage points per annum in recent years." Zhao Yining, *The Financial Situation and Financial Reform*, LIANGWANG [OUTLOOK], May 15, 1995, at 12-13.

9. See Economic Research Institute of the State Planning Commission [now the State Development and Planning Commission], *1995-1996 Hongguan Jingji Xinshi Fenxi [Macro-Economic Situation of the Year 1995-1996]* (1996). The research group picked up a state commercial bank branch and found out that NPLs in that branch at the end of 1994 were RMB 1,162.67 million, seventy times the amount at the end of 1990. *Id.*

in the first three months of 1999 in Shenzhen.¹⁰ Dai Xianglong, the PBOC governor, admitted in his speech at the annual session of the National People's Congress (NPC) on March 11, 1999, that, "owing to the unsatisfactory performance of state-owned enterprises, the trend of increasing non-performing loans has yet to be checked."¹¹

B. NEGATIVE EFFECTS OF NPLS

1. *Negative Effects on State Banks*

The NPL problem has been a major obstacle for state commercial banks to be genuinely commercialized. Huge amounts of bad assets are damaging the profitability and competitive ability of state commercial banks, and impeding them from improving their economic efficiency. If the increasing creation of bad assets cannot be curbed effectively, the NPL problem will eventually lead to the collapse of state banks and consequently the entire banking system.

a. The Decreasing Profitability of State Commercial Banks

NPLs have direct, decreasing effects on bank profits: banks have to write off and provide for NPLs, which decreases their profit substantially. The China Construction Bank (CCB), for example, generated book profits of RMB 2.2 billion (U.S.\$266 million) in 1998. The actual profits, however, were only RMB 850 million (U.S.\$102.7 million), down 44 percent from the RMB 1.51 billion in 1997.¹² Zhou Xiaochuan, then the CCB governor, said the bank experienced an increase in expenditures and a decrease in profits. In addition to the government's cut in interest rates, adjustments made to the bank's interest receivables, and the summer floods, he attributed decreased profits to the increase in provisions for the NPLs.¹³ As shown in Table 1, the average profit margin of the big four during the period from 1995 to 1997 was only 0.26 percent and showed a decreasing tendency, while the profitability of the ten new commercial banks¹⁴ during the same period was 1.70 percent and showed an increasing tendency. One of the reasons that these newly emerged banks overperformed the big four is that they had a very low NPL level.¹⁵

b. The Deteriorating Creditworthiness of State Commercial Banks

The accumulation of NPLs seriously decreases state banks' credit standing, directly evidenced by the downgrading of five Chinese financial institutions by Standard and Poor on

10. It is reported that overdue loans rose by RMB 2.23 billion in the first three months of 1999, an increase of just over twenty-two percent since the end of December last year; bad debts rose by 1.5%. See James Harding, *Bad Loans Soar in Shenzhen*, FIN. TIMES (London), Apr. 17, 1999, at Int'l 4.

11. James Harding, *China to Let Banks Price Lending Risks*, FIN. TIMES (London), Mar. 12, 1999, at Asia-Pac. 6.

12. See, e.g., James Harding, *Banks' Profits Come Under Pressure in China*, FIN. TIMES (London), Jan. 22, 1999, at Asia-Pac. 3.

13. Provisions for NPLs rose by RMB 7.9 billion (U.S.\$954 million) year on year. See, e.g., *China's Top Five Commercial Banks Report 1998 Account Balances*, at http://www.chinaonline.com/top_stories/today_b9012040.html.

14. They are: Bank of Communications, China International Trust and Investment Corporation Industrial Bank, China Everbright Bank, Huaxia Bank, China Minsheng Banking, Guangdong Development Bank, Shenzhen Development Bank, Merchant Bank, Fujian Industrial Bank, and Shanghai Pudong Development Bank.

15. It is estimated that NPLs only account for 2.36% of the outstanding loans of the emerging commercial banks. See, e.g., Liangchun Yu & Yuan Jv, *Monopoly and Competition: Banking Monopoly and Competition in China* [*rongduan yu jingzheng: zhongguo yinghang ye de gaige yu fazhan*], 8 ECON. RES. J. 48, 55 (1999).

Table 1
Profit Margins of Banks in China (percentage): 1995–1997

	1995	1996	1997	Period Average
The Big Four	0.35	0.32	0.12	0.26
Ten New Commercial Banks	1.68	1.60	1.82	1.70
City Commercial Banks	n.a.	2.00	0.91	1.46
Foreign Banks in China	0.73	0.61	0.67	0.67

Source: Table 5 in Liangchun Yu & Yuan Jv, *Monopoly and Competition: Banking Monopoly and Competition in China* [rongduan yu jingzheng: zhongguo yinghang ye de gaige yu fanzhan], 8 ECON. RESEARCH J. 48, 53 (1999).

March 1, 1999.¹⁶ Moody's rated China's average bank financial strength at "D", that is, very weak, in July 1999. That was worse than all other countries being rated except Korea, Pakistan, Thailand, Indonesia, and Russia.¹⁷

c. The Potential Failure of State Commercial Banks and the Entire Banking System

The accumulation of NPLs has historically been one of the direct causes of bank failures. In the United States, loan losses dominated the major bank failures from 1934 to 1983.¹⁸ The recent bankruptcy of China's second largest international trust and investment corporation, Guangdong International Trust and Investment Corporation (GITIC), was more or less due to the large amount of unrecoverable loans.¹⁹

The huge amount of NPLs has already made the big four technically insolvent.²⁰ They

16. See, e.g., James Harding, *Downgrade for Five Financial Institutions*, FIN. TIMES (London), Mar. 2, 1999, at Asia-Pac. 4. Standard & Poor lowered the foreign currency counterpart credit, certificate of deposit, and debt ratings on five Chinese financial institutions: Bank of China (BOC), Bank of Communications (BOCS), CCB, China International Trust & Investment Corp. (CITIC), and Industrial & Commercial Bank of China (ICBC).

17. See *Average Bank Financial Strength Rating by Country*, MOODY'S INVESTORS SERVICE: BANKING SYSTEM OUTLOOK: SINGAPORE (July 1999), at 5.

18. See Reid Nagle & Bruce Petersen, *Capitalization Problems in Perspective*, in HANDBOOK FOR BANKING STRATEGY, Table 9.2 (Richard C. Aspinwall & Robert A. Eisenbeis eds., 1985). Among the twenty failure cases that the authors listed in the table, four of them were caused by loan losses.

19. See, e.g., *GITIC Had 103 More Subsidiaries Than Previously Reported*, Guangdong Government Says, at http://www.chinaonline.com/industry/financial/newsarchive/secure/1999/feb.../fn_c9020802.as. According to an investigation into the bankruptcy, GITIC's total amount of unrecoverable loans, leased assets, investments, and interest on account receivable was RMB 9.6 billion (U.S.\$1.2 billion), or sixty-five percent of the trust's net debt. *Id.*

20. As of 1995, for example, it was revealed that then overdue loans, dead loans, and irrecoverable loans constituted twelve, eight, and two percent, respectively, of the combined value of the loan portfolios of the big four. See, e.g., Tang Xiong, *How to Regard the Bank's Non-Performing Assets*, JINRONG SHIBAO [FIN. NEWS], Apr. 21, 1996, at 5.

Since the loans outstanding of these four institutions at year-end 1995 stood at RMB 3.9 billion, classified loans can be estimated at RMB 860 billion. Of these RMB 469 billion were overdue, RMB 313 billion were dead loans, and RMB 78 billion were irrecoverable. The total net worth of these banks at year-end 1995, including paid-in capital, surpluses, and retained profits, stood at only RMB 269 billion. Deducting the value of irrecoverable loans, the net worth of these institutions would be only RMB 191 billion. If the ultimate recovery rate on the remaining classified loans is less than 3/4, the magnitude of loans to be written off would exceed the remaining net worth of these banks. See NICHOLAS R. LARDY, CHINA'S UNFINISHED ECONOMIC REVOLUTION 119 (1998); see also Li Xinxin, *Looking at China's Hidden Financial Danger from the Perspective of the East Asian Financial Crisis: An Analysis of the Utilization and Management of Assets by China's State-Owned Commercial Banks*, 3 GAIGE (Beijing) 32 (1998). Li Xinxin is one of the few Chinese authors who has explicitly acknowledged that the liabilities of the big four exceed their assets.

are running mainly on the government support and the public's confidence in them.²¹ Or, in Nicholas Lardy's words, "the big four are insolvent, but not illiquid."²²

Taking into consideration the weight of the state commercial banks in the entire banking system,²³ it would not be exaggerating to assert that if the creation of new NPLs cannot be effectively curbed, the accumulating NPLs will eventually pull down the state commercial banks and even the entire banking system in China.²⁴

2. Negative Effects on the Economic Reform and the Growth of Real Economy

a. Negative Effects on the Economic Reform Toward a Market Economy

The building of a market economy requires the creation of markets, market-oriented enterprises, and a wide range of institutions and business practices to support them. For markets to function well there must be a robust entry into, and disciplined exit from, markets to ensure that the most efficient and innovative producers operate in the markets.²⁵

The presence of NPLs on banks' balance sheets distort the incentives for both banks and SOEs. It has been proven that the large amount of NPLs frequently lead to adverse selection of bank and firm managers.²⁶ The large amount of NPLs, relative to the capital of lending banks, suggests that the bank's managers have to bet the bank on the prospect of debtors paying debts. Lenders are forced to consider a workout loan when borrowers lose access to financial markets and must seek new loans from existing creditors to continue servicing outstanding debt.²⁷ The distortion of the lending decision is most extreme if the bank is so heavily exposed to a borrower that the bank would fail if the workout loan were not made. In this case, the bank will be willing to make the loan so long as there is some chance—however negligible—the workout loan will succeed.²⁸ Firms' managers, on the other hand,

21. A survey conducted by the Task Team of the PBOC Huaihua Branch in 1998 shows the public confidence in state-owned commercial banks. See Task Team of the PBOC Huaihua Branch, *Depositors' Consciousness of Financial Risks and the Bank Exit System* [chunkuanren de fengxian yishi yu yinghangye de tuichu zhidu], in 9 JINRONG JINGJI (Changsha) 3–6 (1998).

22. See NICHOLAS R. LARDY, THE CHALLENGE OF BANK RESTRUCTURING IN CHINA IN STRENGTHENING THE BANKING SYSTEM IN CHINA: ISSUES AND EXPERIENCE, 31 (BIS POLICY PAPERS No. 7, Oct. 1999). Lardy lists three factors that allowed insolvent banks to continue to operate. The first is the rising rate of national savings in the reform period. The rate was about thirty percent of GDP at the outset of reform but had risen to forty percent or slightly more by the mid-1990s. Second, the sources of savings have shifted dramatically, so that by the mid-1990s households accounted for about half of all savings, compared with their negligible share at the outset of reform. Third, given the tiny size of China's bond and equity markets and the absence of capital account convertibility, households have had little choice but to hold financial assets either in currency or bank savings deposits denominated in local currency. The combination of these three factors has meant that ever-growing amounts of household savings flow into the banks each year. *Id.* at 31–32.

23. The big four hold 68% of the nation's deposits, seventy-seven percent of all loans, and 75% of the country's total assets, and employs 66% of those working in the banking sector in 1998. See, e.g., *A Look at Bank Reform in China*, Apr. 14, 1999, at <http://www.chinaonline.com>.

24. See, e.g., Chun Jiang, *On the Essence of Finance and Institutional Prerequisites* [lun jinrong de shizhi ji zhidu qiantu], 7 ECON. RES. J. 33, 35 (July 1999).

25. See, e.g., European Bank for Reconstruction and Development, *Transition Report 1998: Financial Sector in Transition*, at iv (1998).

26. See, e.g., Richard J. Herring, *The Economics of Workout Lending*, 21 J. MONEY, CREDIT, & BANKING 1, 5 (Feb. 1989).

27. See *id.* at 1.

28. In other words, additional lending to allow bankrupt firms to service the old loans becomes rational, as it enables banks to report the loans as formally performing, thus delaying the day of reckoning.

are under no pressure to scrutinize their projects: they know that banks have no alternatives but to keep lending. In China, the adverse selection is not limited to banks and SOEs. Most of the adverse selections are under the explicit or implicit instruction of the government.²⁹

The banks' passivity in enforcing loan contracts and their willingness to grant new loans to loss-making SOEs has fostered the reliance of SOEs on state banks and reduced their willingness and ability to adjust their production to changing demands and respond to market signals.³⁰ More seriously, adjusting to soft loans from banks, some enterprises cling to the idea that they do not have a legal obligation to repay loans,³¹ while an acute sense of trust in day-to-day business dealings is essential to business. These negative senses and behaviors of SOEs impede establishing a market economy in China.³²

b. Negative Effects on the Real Economy

It is now well accepted³³ that the performance of the financial sector has a major influence on the performance of the overall economy, by mobilizing domestic and foreign savings and by efficiently allocating these funds to investment opportunities in the real economy; in addition, a sound financial sector is also a source of stability, providing a mechanism for allocating risks and spreading financial losses that inevitably arise from economic activity. The financial crisis in emerging market economies showed how weak banking systems could damage the economy as a whole.³⁴ As banks are the key providers of funds to industry and commerce in China, their fragility certainly can have a negative impact on the real economy.

A banking system burdened with a large amount of NPLs is vulnerable to external shocks. Failures in the financial sector hurt other business and eventually the whole economy.³⁵ This has been fully shown in the failure of the GITIC, which led to the liquidity crisis spreading across China's financial sector—caused by the retreat of international lenders.³⁶

29. See Gangming Yang, *Empirical Analysis on China SOEs' Bad Debts* [zhongguo guoyu qiye buliang fuzhai de shizheng fengxi], 12 ECON. RES. J. 12, 15 (2000).

30. It is reported that 66.7% of 605 key manufactured products in China were in oversupply. That is, to some extent, due to weak market responsiveness of SOEs. See, e.g., James Kynge, *Chinese Products Seen in "Oversupply"*, FIN. TIMES (London), Feb. 5, 1999, at Asia-Pac. 4.

31. In 1999, the PBOC and SETC jointly issued the Report on Collecting Bank Interest Arrears According to Law, which reveals that among all the interest arrears, twenty percent are owed by the debtors who have the capacity to repay the interest. See Circular of the General Office of the State Council on Issuing the Report of the PBOC and the SETC on Collecting Bank Interest Arrears According to Law (Jan. 21, 1999).

32. The entire society of China lacks the sense of credit. People do not consider their obligation to repay debts. See, e.g., Genyun Gu, *On Financial Crisis and Its Legal Countermeasures*, 12 LAW SCIENCE [FA XUE: SHANGHAI] 45, 47 (Dec. 1998).

33. There is much literature demonstrating a significant correlation between financial development and growth, including: Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might Be Right*, 53 Q.J. ECON. 715 (Aug. 1993); Marco Pagano, *Financial Market and Growth: An Overview*, 37 EUR. ECON. REV. 613 (Apr. 1993); and Joseph E. Stiglitz, *Financial Market and Development*, 5 OXFORD REV. ECON. POL. 61 (1989). The positive correlation between financial development and economic growth exists in China as well. See Ruyong Tan, *An Empirical Study of the Relationship Between China's Financial Development and Economic Growth* [zhongguo jinrong fazhazhang he jingji zhengzhang guanxi de shizheng yanjiu], 10 ECON. RES. J. [JINGJI YANJIU] 53 (Oct. 1999).

34. See Rudi Dornbusch & Francesco Giavazzi, *Heading off China's Financial Crisis*, in STRENGTHENING THE BANKING SYSTEM IN CHINA: ISSUES AND EXPERIENCE 40 (1999).

35. For an economic analysis, see, for example, Nobuhiro Kiyotaki & John Moore, *Credit Cycles*, 105 J. POL. ECON. 211 (1997).

36. See, e.g., James Harding, *Foreign Banks Get Tough with Chinese Borrowers*, FIN. TIMES (London), Feb. 8, 1999, at Asia-Pac. 5; James Harding, *Foreign Banks Look to Reduced Role in a Bruised China*, FIN. TIMES (London),

Moreover, the GITIC bankruptcy led directly to the downgrading of China's state-owned banks and investment companies—Standard and Poor assigned a “junk” rating to China International Trust and Investment Company (CITIC), the BOC, the CCB, and the ICBC.³⁷

Even without external shocks, large amounts of NPLs have negative impacts on the real economy.³⁸ Some economists contribute the 1998 growth slowdown in China to excess capacity in industry, banking sector stress, low consumer confidence, and low export growth. With regards to banking sector stress, economists point out that the huge amount of NPLs, combined with the Asian financial crisis, caused tensions in the Chinese government and the banking sector—banks became cautious about increasing lending, and many projects with uncertain returns were rejected.³⁹ There were company complaints that many banks avoided giving out loans because of rising bad debt levels.⁴⁰

III. Causes of Bank NPLs—A Theoretical Framework

Before we start to investigate the causes of NPLs in China, it is important to recognize that, unlike in Eastern and Central European countries,⁴¹ most NPLs of Chinese banks were not inherited from the pre-reform era. Instead, they were mostly created after reform began.⁴² Dai Xianglong stated that the NPL problem in China resulted from the transformation of the country's economic system.⁴³

China's economic reform is in transition from a planned economy to a market economy.⁴⁴ The main idea is for market mechanisms to be the main integrators of the economy—this

Jan. 27, 1999, at Asia-Pac. 5; James Harding, *GITIC Failure Hurts Other Businesses*, FIN. TIMES (London), Jan. 22, 1999, at Asia-Pac. 3; and Louise Lucas & James Harding, *Confidence in China Suffers as GITIC Debt Revealed*, FIN. TIMES (London), Jan. 11, 1999, at Asia-Pac. 1.

37. See, e.g., Lawrence J. Lau, *The Macro-economy and Reform of the Banking Sector in China*, in STRENGTHENING THE BANKING SYSTEM IN CHINA: ISSUES AND EXPERIENCE, *supra* note 34, at 59, 78 (1999).

38. The massive overhang of bad debt stifles new, higher-quality lending by the state banks and acts as a drag on new economic growth. Banks have to make provisions for these loans. High provisioning needs are pushing banks to put available cash aside for potential losses instead of making the new loans needed for the economy. This consequence has already been seen in countries such as Japan and Thailand. In Japan, bank lending fell some four percent, while the economy shrank 2.5%. That is largely due to the dicey state of banks. Because they are carrying \$600 billion of NPLs on their books, they are leery of lending to companies. See, e.g., Ted Bardacke, *Bad Loans Total 44% of All Lending by Thai Banks*, FIN. TIMES (London), Mar. 3, 1999, available at 1999 WL 3449778; Brian Bremner, *Why Japan Is Struck*, BUS. WEEK, Apr. 12, 1999, available at 1999 WL 8226852.

39. See generally Renhong Wu, *China's Economic Outlook*, May 4, 1999, at <http://www.chinaonline.com>.

40. These complaints were dismissed by the PBOC. According to a PBOC survey, large- and mid-sized companies with healthy profits were still getting needed loans, although credit controls were more stringent and companies were being forced to look for needed capital through other channels. The survey found out those enterprises were turned down largely because of their poor credit record. See *China's Bank Loans on Target*, XINHUA ENGLISH NEWswire, Apr. 5, 1999, available at 1999 WL 7931582.

41. In Hungary, for example, from 1987 to 1991, more than fifty-one percent of the outstanding bad debts were concentrated in big banks. They inherited the bad debts of the big companies granted by the National Bank of Hungary in their one-tier banking system. See, e.g., Sandor Ligeti, *Problem Loans*, in IEF RESEARCH PAPERS IN BANKING AND FINANCE 93/13, 7 (1993).

42. See LARDY, *supra* note 20, at 220.

43. See, e.g., *China Will Not Suffer a Financial Crisis: Official*, XINHUA ENGLISH NEWswire, Apr. 3, 1999, available at 1999 WL 7931322.

44. See World Bank, *China 2020: Development Challenges in the New Century*, CHINA 2020, Box 2.1 (1997). For a detailed discussion about the evolution of the aims for China's economic reform, see Zongling Shen & Jianbo Lou, *The Contemporary Socialist Market Economy and the Law of the People's Republic of China*,

embraces far-reaching decentralization, a high degree of autonomy for the firm, and liberalization of prices, with the predominance of state-ownership and the pervasive role of state control.⁴⁵ In this sense, China's reform is no different than the socialist market reform defined by Janos Kornai⁴⁶ and bears the exact problems he pointed out—the bureaucratic coordination of the command economy is lifted without true market discipline being applied.⁴⁷ In the rest of this section, the author will argue that it is the failure of market discipline that has resulted in huge amounts of NPLs on the balance sheets of Chinese state banks.

A. SOFT BUDGET CONSTRAINTS

In China's planned product economy, enforced until 1978, enterprises had few incentives to increase profits and no penalties for not covering cost—an accommodating and paternalistic state (in the shape of the Ministry of Finance and/or superior branch departments) would always ensure that enterprises survived. Kornai describes enterprises in this situation as enterprises operating under soft budget constraints.

1. *The Concept of Soft Budget Constraints and Its Application*

The concept of soft budget constraints was first introduced by Janos Kornai in 1980.⁴⁸ Kornai defines budget constraints as a rational planning postulate with two important properties: first, the budget constraint refers to a behavioral characteristic of the decision maker (he adjusts his expenditures to his financial resources); second, the budget constraint is a constraint on ex ante variables and first of all on demand (it is based on expectations concerning his future financial situation when the actual expenditure will occur). The "softening" of budget constraints appears when the strict relationship between expenditure and earnings is relaxed, that is, when excess expenditure over earnings will be paid by some other institution, typically by the state. A further condition of "softening" is that the decision maker expects such external financial assistance with high probability and this probability is firmly built into his behavior.

Kornai's conceptual framework for analyzing socialist economies is most widely used in

Address at the XV International Conference of Comparative Law Academy, Bristol (Aug. 1998); *World Bank*, *supra*, Box 1.3; and Tianying Li, *The Foundation of Socialist Market Economic Theory and a Significant Breakthrough—in Commemoration of the 20th Anniversary of the 3rd Plenary Session of the 11th Central Committee of CPC* [shehui zhuyi shichang jingji lilun de xingcheng he zhongda tupo jinian zhongguo gongchandang di shiyijie sanzong quanhui ershi zhounian], 3 *ECON. RES. J.* 3 (1999).

45. See Jiang Zemin, *Accelerate the Reform and Openness, Promote the Modernization Drive, Striving for New Victories in the Way of the Socialism with Chinese Characteristics*, Address at the 14th National Congress of the CPC, in *PEOPLE'S DAILY*, Oct. 13, 1992, at 2.

46. Janos Kornai characterizes reform socialism with (1) the ruling role of the Communist party somewhat mitigating the repression and allowing a degree of freedom for alternative views; (2) the pervasive role of state control and the subordination of the economy to the bureaucracy; (3) the predominance of state-ownership; (4) the development of market coordination as the main integrators of the economy; and (5) the development of the private sector confined with some limits. See JANOS KORNAI, *HIGHWAY AND BYWAYS: STUDIES ON REFORM AND POST-COMMUNIST TRANSITION* 59 (1995).

47. See *id.* at 44-45; and JANOS KORNAI, *THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM* 497-98 (1992).

48. See JANOS KORNAI, *ECONOMICS OF SHORTAGE* (1981). For a more detailed explanation of the concept, see Janos Kornai, *The Soft Budget Constraint*, 39 *KYKLOS* 1, 3 (1986).

discussing the economies of Eastern Europe,⁴⁹ although it has been more recently applied to China by Kornai himself⁵⁰ and other western scholars,⁵¹ as well as Chinese scholars.⁵² Their applications, however, mainly test the concept with China, instead of using the theory to analyze some more specific issues.

2. Consequences of Soft Budget Constraints

The soft budget constraint on firms has many interrelated consequences.⁵³ As for its impact on a firm's conduct, three consequences can be identified: weak price responsiveness, low efficiency, and excess demand.⁵⁴ The softness of budget constraints diminishes the firm's sensitivity toward price fluctuation and, thereafter, invalidates the banks' efforts to curb unsustainable borrowing by charging high interest rates. Weak price responsiveness can lead to low efficiency of firms: allocation efficiency cannot be achieved when input-output combinations do not adjust to price signals. Under soft budget constraints, there is not a sufficiently strong stimulus to maximize firm profits. More seriously, when the external circumstances are unfavorable, the firm is not forced to adjust to the changed situation; instead, it is likely to seek external assistance, asking for compensation for unfavorable external circumstances. A third consequence of the soft budget constraint syndrome may show up in the formation of excess demand. Whatever goals the managers of the firm have (maximizing short- or long-term profits, sales, growth of sales, size of the firm, discretion, and power), these objectives, or any combination of them, will be associated with expansion. This is what Jonas Kornai terms "investment hunger syndrome."⁵⁵

3. Sources of Soft Budget Constraints

The soft budget constraint has a number of sources. Kornai points to soft subsidies granted by national or local government, soft taxation (under this, firms suffering difficulties are granted tax concession or allowed to postpone payment of their taxes), soft credit, and soft administrative prices.⁵⁶ Among them, soft credits contribute directly to NPLs.

49. See, e.g., Janos Kornai, *The Hungarian Reform Process: Visions, Hopes and Reality*, 24 J. ECON. LITERATURE 4 (1986).

50. See, e.g., Kornai, *supra* note 48; and JANOS KORNAI, VISION AND REALITY, MARKET AND STATE: CONTRADICTIONS AND DILEMMAS REVISITED 35–36, 192–93 (1990).

51. See, e.g., Mario I. Blejer & Gyorgy Szapary, *The Evolving Role of Tax Policy in China*, 14 J. COMP. ECON. 452 (1990); Paul Bowles & Gordon White, *Contradictions in China's Financial Reforms: The Relationship Between Banks and Enterprises*, 13 CAMBRIDGE J. ECON. 481 (1989); and Christine P.W. Wong, *The Economics of Shortage and Problems of Reform in Chinese Industry*, 10 J. COMP. ECON. 363 (1986).

52. See, e.g., Sidong Jiang et al., *Financial Reform, the Two-Track System: Strengthen Credit Restraint, Open Up a Capital Market Among the People*, in CHINESE ECONOMIC STRUCTURAL REFORM RESEARCH INSTITUTE (BEIJING): RESEARCH REPORTS No. 25 (Nov. 29, 1985).

53. For a detailed discussion of all those consequences, see JANOS KORNAI, CONTRADICTIONS AND DILEMMAS: STUDIES ON THE SOCIALIST ECONOMY AND SOCIETY 42–44 (1986).

54. Kornai, *supra* note 48.

55. A constant insatiable investment hunger is an apparent syndrome under the classical socialist system. See KORNAI, *supra* note 46, at 189. Overinvestment was a chronic problem during China's classical socialist period. For a detailed discussion of it, see Hsin Chang, *The 1982–83 Over-investment Crisis in China*, 24 ASIAN SURV. 1277 (1984). The investment hunger syndrome survived the economic reform started in 1978 with two new characteristics. One is a rise in the proportion of a firm's profits that it need not hand over to the state budget and can use to finance investment of its own. The other is a reduction within the entirety of the outside resources for investment in subsidies from the state budget that need not be repaid and increase in bank credits that have to be repaid with interest.

56. See, e.g., KORNAI, *supra* note 47, at 140–42, 489; KORNAI, *supra* note 48, ch. 13.

B. MARKET DISCIPLINE—A MECHANISM TO CURB SOFT CREDIT

1. *General Introduction—The Theory of Market Discipline*

Market discipline is by no means a new concept to the financial world. Whenever there are doubts about the efficiency and effectiveness of financial regulation, people turn to concepts such as market force, market place, or market discipline in the hope that the market can solve problems better than state intervention. William McDonough, president of the Federal Reserve Bank of New York and Chairman of the Basle Committee, when talking about the reform for the 1988 Basle Accord, insisted on the need for reliance on market discipline and said that “[t]he new framework was supposed to include ‘as great as possible a reliance on market discipline, with emphasis on transparency and disclosure.’”⁵⁷

Timothy Lane developed the theory of market discipline by studying the experience of federal unions, ranging from tight central control of borrowing by lower levels of government to virtually complete reliance on market forces; evidences regarding sovereign debt; the relationship between market discipline and financial regulation; and soft budget constraints in socialist countries.⁵⁸ He discovered that in the diverse cases examined, the conditions required for market discipline are essentially the same: openness and competitiveness of capital markets; availability of information on the borrower’s outstanding liabilities; no expectation for bail-out; and the borrower’s capability and willingness to respond to market signals provided by interest rate spreads. Evidence suggests that although market discipline is an important force, it is not always strong enough to prevent unsustainable borrowing because of the failed conditions of market discipline, especially the “no-bailout” condition. It is often difficult to make such a condition credible. Lane recommends reinforcing market discipline by some kind of direct controls or rules, stressing the importance of implementing measures to strengthen market discipline itself.

Jonas Kornai, who has done thorough studies on the post-socialist economy, uses the term “financial discipline” synonymously with market discipline. He defines financial discipline as the enforcement of four simple rules: (i) buyers pay for the goods they buy, (ii) debtors abide by the loan contract and pay back debt, (iii) taxpayers pay their taxes, and (iv) enterprises cover their costs out of their revenues. Although these rules are self-evident in a market economy, Kornai acknowledges they are far from obvious in a socialist command economy—characterized with soft budget constraint. After analyzing Hungary’s experiences in introducing these new rules, he made two conclusions: (i) a range of prior conditions must be satisfied before the financial discipline can be firmly imposed, and (ii) a long period of time must pass before the actors in the economy believe that market discipline is being imposed.⁵⁹

2. *Market Discipline as a Mechanism to Curb Unsustainable Borrowing and Its Conditions*

Unsustainable borrowing, that is, borrowing without the means or even the intention of repaying, directly leads to NPLs. Market discipline is one force that may limit such abuse of financial markets: market discipline implies that lenders penalize excessive borrowing, first, by requiring a higher interest rate spread and, ultimately, by excluding the borrower

57. *Basle to Keep Partial Modeling*, INT’L BANKER, Apr. 12, 1999, available at 1999 WL 5992038.

58. See generally TIMOTHY D. LANE, MARKET DISCIPLINE (IMF Working Paper WP/92/42, June 1992).

59. KORNAI, *supra* note 46, at 141–60.

from the market.⁶⁰ Nicolas Lardy expands the lender's discipline function to the time after the funds are lent. Once funds are lent, the lender monitors the borrower to ensure that the use of funds is consistent with the loan contract. Most importantly, they can force borrowers who fail to amortize their loans on a timely basis either to restructure them in order to survive or to exit.⁶¹ If market discipline works effectively, credit will be hardened and hence unsustainable borrowing can be efficiently curbed.

Market discipline will not work for itself, however. As mentioned above, there are four conditions for market discipline to work effectively. Failure of any of these conditions will lead to the failure of market discipline.⁶²

a. Open and Competitive Capital Markets

This is required so that unsustainable borrowing will face the borrower with increased interest rates or exclusion from the market. In the case of financial institutions, if legal restrictions that limit competition for deposits—such as geographic scope of activities, or on the activities permitted to particular categories of institutions—give particular institutions a degree of market power, this may reduce the market's ability to discriminate between prudent and imprudent financial intermediaries, and thereby render market discipline ineffective. In the case of SOEs in reforming socialist economies like China, if financial institutions are directed by the authorities to lend to particular enterprises regardless of their creditworthiness, financial discipline will be nullified.

b. Information

A second requirement for effective market discipline is to allow lenders to obtain relevant information about the borrower's outstanding debts. Due to the imperfect accounting rules, financial institutions can conceal their losses from both creditors and regulators. This seriously undermines the market discipline. The information problem has been studied extensively after the burst of the Asian financial crisis. The International Monetary Fund (IMF), in a report about the Asian financial crisis, concluded that weakness in disclosure practices in the Asian crisis countries allowed excessive risk-taking.⁶³ The weaknesses identified by the IMF include:⁶⁴ (1) High corporate leverage was hidden by related-party transactions and off-balance sheet financing; (2) High-level foreign exchange risk exposure by corporations and banks resulting from large, short-term borrowing in foreign currency was not evident; (3) Disclosure of loan classification, loan loss provisioning, and accrual of interest was weak. Although most banks disclosed the accounting policy for loan-loss provisioning, they did not disclose in the balance sheet the aggregate amount of loans and advances for which they had stopped accruing interest; (4) In Korea, the practice of cross-guarantees made it hard to assess the solvency of the largest borrowers; (5) Consolidation of accounts was generally absent; (6) Detailed information on sector concentration was largely absent, even though all countries had large exposure limits in place; (7) Disclosure regarding derivative financial instruments was weak; and (8) Contingent liabilities of the

60. LANE, *supra* note 58.

61. LARDY, *supra* note 20, at 59–60.

62. See Graham Bishop et al., 1992 AND BEYOND: MARKET DISCIPLINE CAN WORK IN THE EC MONETARY UNION (1992); and Jacob A. Frenkel & Morris Goldstein, *Monetary Policy in an Emerging European Economic and Monetary Union*, 38 IMF STAFF PAPERS 356 (June 1991).

63. See Tomás J.T. Balino et al., *Financial Sector Crisis and Restructuring Lessons from Asia*, in 2000 IMF OCCASIONAL PAPER 188 (1999).

64. See *id.* Box 2.

parent of conglomerate, or of financial institutions, for guaranteeing loans (particularly foreign currency loans) were generally not reported. Andrew Sheng, the chairman of the Hong Kong Securities and Futures Commission, summarized the information problem as "Bad accounting = bad information = poor decision-making = bad risk management = financial crisis."⁶⁵

In the case of SOEs in socialist economies, the need for timely information to assess enterprises' creditworthiness is always frustrated by the unavailability of necessary information and the incapability of bank loan officers to find and process the relevant information.

c. No Bailout

For market discipline to be effective, it is necessary that there is no anticipation of a bailout in the case of (actual or impending) default. This condition is the most crucial and its failure is probably the most important reason for the failure of market discipline.

In formerly planned economies, even as reforms proceed, banks are often content to continue lending to insolvent enterprises in the belief that the authorities will make good on the loans. Even if authorities would like to promote efficiency by committing themselves not to bail out insolvent enterprises, such a commitment may not be credible. Once a large enterprise's failure is impending, the government's best response, in view of the possible losses of output and employment, may be to bail out the enterprise.⁶⁶

d. Borrower's Response

Market discipline takes two forms: initially, the borrower faces a rising interest rate spread and eventually access to further credit is denied. Because the second stage is often associated with a financial crisis, it is not a normal form of market discipline. Thus, a condition for the smooth operation of market discipline is that borrowers respond to the signals provided by the market in time to avoid a crisis.

A rational agent, when faced with a higher interest rate, would respond by reduced borrowing in order to get back onto a sustainable path. In fact, if a rational agent possessed as much information as the lender did, it would not wait for a market signal: a rational borrower would anticipate that further borrowing would lead to a higher interest rate spread, and, taking that knowledge into account, would refrain from unsustainable borrowing. Borrowers who believe that there is a high probability of insolvency, however, will not respond to market signals or anticipate them: they have nothing to lose by borrowing, even at a high interest rate.⁶⁷ In other words, market discipline does not work through interest rate spreads if borrowers are already near insolvency; it can only work by excluding insolvent borrowers from the market.

65. ANDREW SHENG, *THE FRAMEWORK FOR FINANCIAL SUPERVISION: MACRO AND MICRO ISSUES IN STRENGTHENING THE BANKING SYSTEM IN CHINA: ISSUES AND EXPERIENCE* 154, 161-62 (BIS POLICY PAPERS No. 7, Oct. 1999).

66. See generally Mark E. Schaffer, *The Credible-Commitment Problem in the Center-Enterprise Relationship*, 13 J. COMP. ECON. 359 (1989); see also DANIEL HARDY, *SOFT BUDGET CONSTRAINTS, FIRM COMMITMENTS, AND THE SOCIAL SAFETY NET* (IMF Working Paper WP/91/98, Oct. 1991).

67. This is the problem of adverse selection, which has been used as the basis for an explanation of credit rationing in private credit markets. Lenders may not be able to identify these borrowers, and there is no limit to how much a borrower who plans to be delinquent would like to borrow, so there is a need for credit to be rationed. See Joseph Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 73 AM. ECON. REV. 393 (1981). The restrictions on large exposure can be reasoned on this ground as well.

C. FAILURE OF MARKET DISCIPLINE—THE ULTIMATE ROOT OF THE NPL PROBLEM IN CHINA

Applying the theory of soft budget constraints and market discipline to China, if budget constraint were hardened and market discipline were working effectively, state banks would not lend to SOEs unless they are ensured that borrowers are willing to and capable of repaying loan interests and principles. Hard budget constraints and market disciplines on SOEs would prevent them from borrowing to finance loss-making productive activities that are never expected to turn profitable. The efficient functioning of market discipline could thus prevent the creation of NPLs, or at least reduce the amount of NPLs to an acceptable level: defending the soundness and safety of the banking system. The huge amount of bad assets with state banks, therefore, provides evidence that market discipline is not working effectively in China, and soft budget constraints still apply to SOEs. The veracity of this assumption will be tested in the next section.

IV. Causes of NPLs—Empirical Analyses

A. BANK-CENTRIC FINANCE AND STATE-BANK-DOMINATED FINANCIAL SYSTEM

1. *Bank-Centric Finance in China*

China is still in the stage of bank-centric finance,⁶⁸ bank lending—often directed by government policy—dominates enterprise finance, and bank deposits dominate individual investment.

Various reasons can be attributed to the bank-centric finance in China.⁶⁹ The most important reason is that bank-centric finance fits the need of the Chinese government to direct savings from the personal sector into the financing of industrial development and infrastructure, which can be instituted and controlled from above.⁷⁰ The relatively small role of capital markets is not purely a product of market forces; it is also a product of administrative decree. The authorities feared that unrestrained capital market development would drain resources from the state commercial banks, and use credit plans to set quotas on how much equity and securitized debt can be issued in a given year.⁷¹

a. Underdeveloped Capital Markets⁷²

The Central Government restarted selling treasury and other types of government bonds in 1981. SOEs, investment companies, and state-owned financial institutions were author-

68. For definitions and description of bank-centric finance and market-centric finance, see, e.g., Kevin L. Mellyn & Matthew I. Saal, *A Perspective on the Risk and Regulatory Implications of Market-Centric Financial Systems*, at <http://www.iif.com/pressrel/1998pr14.html>.

69. For a detailed discussion about the reasons, see generally Statistics Department of the PBOC, *An Analysis of the Direct Finance of Chinese Enterprises*, 9 CHINA FIN. (Beijing) 24 (1998) [hereinafter *Analysis of the Direct Finance*].

70. China has long aimed at establishing a bank-centric financial system since the economic reform. See generally Liu Hongru, *Developments in the Reform of China's Banking and Financial System*, 2 J. CHINESE L. 323 (1988).

71. See, e.g., World Bank, *supra* note 44, at 33. In 1997, for example, the quota for enterprise-convertible bonds was RMB 4 billion. The quota assignment for stock issuance was removed in 2000. On March 16, 2000, the State Council approved the Procedures of China Securities Regulatory Commission for Examining and Approving Stock Issuance (*zhongguo zhengjianhui gupiao faxing hezhun chengxu*), approved by the State Council on March 16, 2000. The new procedures eliminated quota assignment and administrative recommendations.

72. For a brief description of the pre-1995 development of China's securities markets, see FRANCIS A. LEES & K. THOMAS LIAW, *FOREIGN PARTICIPATION IN CHINA'S BANKING AND SECURITIES MARKET* 59–88, 89–123 (1996).

ized to sell bonds beginning in 1986. But markets for these debt instruments developed extremely slowly. From 1987 to 1995, the value of all bond issues in a year had never exceeded 20 percent of the total value of investment by state-owned units.⁷³ Enterprise bond issues have been especially small.⁷⁴ Between 1995 and 1997, the annual value of enterprise bond issues accounted for less than 3 percent of the total enterprise finance (see Table 2).

The stock markets were created in the 1980s when provincial legislatures began to experiment with company regulations, and locally chartered companies began to issue shares to sell to the public.⁷⁵ Two stock exchanges—Shanghai Stock Exchange and Shenzhen Stock Exchange—opened in 1990 and 1991, respectively. In addition to firms listed on foreign exchanges, by the end of 1999, there were 949 companies listed in domestic stock exchanges, and forty-six companies listed abroad, raising capital altogether equivalent to approximately RMB 400 billion.⁷⁶ In 1998, the issuance of stock accounted for 15 percent of the country's total amount of financing raised annually.⁷⁷

At the end of 1999, there were 1,209 securities on the stock exchanges, with 1,032 A-shares, 108 B-shares, 45 funds, and 26 bonds;⁷⁸ the market capitalization was RMB 2,650 billion, or equivalent to 32 percent of China's GDP.⁷⁹ In G-10 countries, the market capitalization of their stock markets now represents well over 100 percent of their GDP.⁸⁰ It is estimated by the World Bank that even if capital markets in China grow at more than twice the rate of projected GDP growth (in real terms), by 2020 the value of stocks and bonds relative to China's economy would only approach that in India's capital market today (70 percent of GDP).⁸¹

b. The Domination of Bank Lending in Enterprise Finance

In contrast to the underdeveloped capital markets is the dominating role of bank lending in enterprise finance. Bank lending accounted for about 90 percent of finance in China in 1998.⁸² With regards to enterprise finance, the proportion of bank borrowings accounted for over 80 percent from 1995 to 1997 (see Table 2).

c. The Domination of Bank Deposits and Savings in Household Finance Assets

The bank-centric finance in China is also reflected in the structure of household finance assets. The household financial assets in China, although diversified in recent years, are still dominated with bank deposits and savings. In 1997, bank deposits and savings accounted

73. See World Bank, *supra* note 44, fig. 3.8.

74. Enterprises in China have been allowed to issue bonds since the late 1980s.

75. See Anthony Neoh, *China's Domestic Capital Markets in the New Millenium* (Aug. 21, 2000), at http://www.chinaonline.com/commentary_analysis/economics/currentnews/secure/c00082143.asp.

76. According to the CSRC Chairman Zhou Zhengqing, *Securities Market Is to Play More Important Role in China's Economy* [zhongguo zhengquanhui zhushi zhou zhengqing cheng zhengquan shichang jiang fahui genjian zhongyao de zhouyong], PEOPLE'S DAILY (Overseas Ed.), Jan. 8, 2000, at 5 [hereinafter CSRC Chairman].

77. See *Some Investors Still Bullish on China's Listed Companies*, at http://www.chinaonline.com/top_stories/today_b2_99011818.html (last visited Oct. 6, 2000) [hereinafter *Some Investors Still Bullish*].

78. See Qin Pan, *A New Stage for China's Securities Markets* [zhongguo zhengquan shichang maishang xin taijie], PEOPLE'S DAILY (Overseas Ed.), Jan. 22, 2000, at 5.

79. CSRC Chairman, *supra* note 76.

80. Neoh, *supra* note 75.

81. World Bank, *supra* note 44.

82. See, e.g., Xuejun Jiang & Yan Liu, *China's Financial Structures*, 6 CHINA FIN. (Beijing) 43 (1998).

	1995		1996		1997	
	Amount (RMBbn)	Percentage to the Enterprise Finance in the Aggregate	Amount (RMBbn)	Percentage to the Enterprise Finance in the Aggregate	Amount (RMBbn)	Percentage to the Enterprise Finance in the Aggregate
Enterprise Finance in the Aggregate	1147.1	100	1345.8	100	1479.5	100
Bank Borrowing	1014	88.4	1114	82.8	1140	77
Share Issues	10.3	0.9	42.5	3.2	127.5	8.7
Bond Issues	21.6	1.9	26.8	2	25	1.7
Commercial Papers	101.2	8.8	162.5	12	186	12.6

Sources: Statistics Department of the PBOC, *An Analysis of the Direct Finance of Chinese Enterprises*, 9 CHINA FIN. (Beijing) 1998, at 24.

for more than 80 percent of all household financial assets, securities only accounted for approximately 10 percent, and cash and other assets less than 10 percent.⁸³

d. High-Leverage Ratio in Enterprises and High-Level of NPLs—

A Direct Consequence of Bank-Centric Finance

Bank-centric finance often leads to high-leverage ratios in enterprises, especially when it is combined with oversaving. One logical consequence of oversaving is that companies could access cheap capital from the banks for a long time. This often leads to imprudent investment and expansion on the basis of debts. The debt-asset ratio is currently 65 percent and 71 percent respectively for state enterprises and collective enterprises,⁸⁴ which has meant that banks and enterprises are so intertwined that industrial collapse would pull down individual banks or even the entire banking system.

Moreover, a bank-centric finance system easily creates NPLs within its banking sector because people left most of their financial resources in the banks to earn a risk-free return. Banks have to lend the money out to make profits. When easy money is flooding to companies and projects such as real estate development, a bubble will be created in the property sector and the stock market, as well as huge overcapacity in the manufacturing sector. Later, when the economy slows down, the bubble bursts, companies are left with large amounts of unsold goods, and banks end up with massive amounts of NPLs.⁸⁵ This argument is supported by international experiences that the ratio of NPLs to GDP in bank-centric finance economies are usually higher than that in other countries suffering from a financial crisis.⁸⁶

2. *The Domination of State Commercial Banks*

a. The Big Four-Dominated Financial System

The bank-centric finance in China is closely connected to a bank-dominated financial system in China. China has a financial system that is heavily dominated by banks. Their share of financial intermediation is almost nine-tenths, a ratio exceeding that found in almost all other Asian countries.⁸⁷ Further, because virtually all banks in China are state owned, the bank domination in China is reflected in state-bank domination.

Although a variety of institutions are populating China's financial sector and there is now a nucleus of potential competition between commercial banks, state commercial banks, especially the big four, are still dominating the banking sector (see Table 3). The profits of the big four accounted for 50 percent of the profits in China's banking system in 1998.⁸⁸

83. *Analysis of the Direct Finance*, *supra* note 69.

84. Wu, *supra* note 39. Even the listed companies have much higher debt-asset ratios. The 1997 average debt-asset ratio of Chinese listed industrial companies was 47.7%. *Some Investors Still Bullish*, *supra* note 77.

85. See, e.g., Yonghao Pu, *How to Save China from Oversaving?*, June 28, 1999, at <http://www.chinaonline.com>.

86. See World Bank, *Global Economic Prospects 2000 Report*, 73 (Dec. 1999). That ratio has been twenty-seven percent in South Korea, thirty percent in Malaysia, sixty percent in Thailand, and twenty-five percent in Indonesia. In contrast, NPLs in other major emerging market crises (Chile in the early 1980s and Mexico in 1995) were less than twenty percent of GDP. In the Scandinavian banking crises, NPLs amounted to approximately five percent of the GDP. East Asia's heavy reliance on bank-based financial systems and the high debt-equity ratios of corporations have made the economic distress especially acute. *Id.*

87. See LARDY, *supra* note 20, at 16.

88. See, e.g., S & P Downgrades Hit China's Big Banks When They Can Least Afford It, at <http://www.chinaonline.com>.

Table 3
China's Financial Institutions (Excluding Securities and Insurance Companies) and Their Asset Amounts by the End of 1998*

	Amount of Assets (trillion yuan)	Percentage of the Financial Assets in Aggregate
Financial Assets in the Aggregate	15.25	100
"Big Four" State Commercial Banks	9.5	62.30
Three Policy Banks**	1.38	9.05
Fourteen Small Commercial Banks***	1.68	11
Foreign Banks	0.28	1.8
Rural and Urban Credit Cooperatives	1.65	10.8
Trust and Investment Companies****	0.54	3.5

Note: * The PBOC is not included.

** They are: State Development Bank, Export and Import Bank of China, and Agricultural Development Bank of China.

*** They include three state-held banks (BOCOM, China Everbright Bank, and CITIC Industrial Bank), three public-held banks (China Merchants Bank, Huaxia Bank, and China Minsheng Banking Corporation), and a number of regional commercial banks such as Shenzhen Development Bank, Hainan Development Bank, Fujian Industrial Bank, Guangdong Development Bank, and Pudong Development Bank. Most of them were established in the 1990s.

**** China is now planning to restructure its ITIC industry. See, e.g., Lana Wong, *Beijing Details Clean-Up of Troubled ITIC Sector*, S. CHINA MORNING POST, Apr. 17, 1999, at 1.

Source: *Profile-China Banking Services*, ASIA PULSE, Apr. 1999, available at 1999 WL 5095417.

They hold 68 percent of the nation's deposits, 77 percent of all loans, 75 percent of the country's total assets, and employ 66 percent of those working in the banking sector.⁸⁹ At year-end 1996, the assets of China's largest bank, the ICBC, was RMB 3.6 trillion, an amount equivalent to just over half of China's GDP in the same year. The assets of the CCB, the second largest, were RMB 2.1 trillion, 30 percent of GDP. Even by the standards of Asia's bank-dominated financial systems, these two banks accounted for an unusually high share of credit creation. Malaysia's biggest lender, Malayan Banking, had assets of less than 40 percent of GDP in 1997. The ratio for the biggest Thai bank, Bangkok Bank, was 25 percent. In contrast, the biggest bank in the United States, Chase Manhattan, controls assets equal to only 4 percent of GDP.⁹⁰ Thus, China appears to be an extreme example of the Asian pattern where a few banks loom very large on the financial landscape and competition is very limited.⁹¹

89. *A Look at Bank Reform in China*, *supra* note 23.

90. See LARDY, *supra* note 20, 165-66.

91. In all Asian crisis countries, commercial banks dominate the financial system. At the end of 1996, total assets of the Indonesian financial system were equivalent to about ninety percent of GDP, with commercial banks holding eighty-four percent of total assets. In South Korea, the total assets of the system were close to 300% of GDP, with commercial banks alone accounting for fifty-two percent of the total assets, while specialized and development banks accounted for seventeen percent. In Malaysia, total assets of the system were equivalent to 300% of GDP, with commercial banks accounting for seventy percent of the total assets of the banking system (comprising the commercial banks, finance companies, and merchant banks). In Thailand, total assets of the system amounted to the equivalent of 190% of GDP, with commercial banks alone accounting for sixty-four percent of total assets. See Balino, *supra* note 63, at 19.

b. State Commercial Bank Domination: Captive Finance Markets

As we have mentioned before, one condition of market discipline is that capital markets must be open and competitive. This is required so that unsustainable borrowing will face the borrower with increased interest rates. A bank-dominated financial system is a captive market where households and enterprises are left with very few choices but to deposit or save their money with banks, no matter how high or low the interest rates.⁹² In a state bank-dominated financial system, it is hard to require that state commercial banks operate as genuine commercial banks because they do not face substantial competition.

B. SOFT BUDGET CONSTRAINTS ON SOEs IN THE FORM OF SOFT CREDIT

As mentioned before, soft credit is one of the four main sources of soft budget constraints. The other three are state subsidies, soft tax, and administrative prices. All four forms of soft budget constraints existed in China before the economic reform, and to some extent exist today. With the development of economic reform, however, soft credits are gradually taking the place of other forms of soft budget constraints.

The concept of soft credit denotes the whole life cycle of a loan. In the author's view, lending is only the beginning of the life cycle of a loan. A complete loan cycle includes the enforcement of the remainder of the loan contract as well. Without rigorous enforcement of the loan contract, even a loan based on proper commercial standards will become sour. Under soft credit, banks lend without carefully assessing their borrowers' creditworthiness. After a loan is granted, the banks are passive in enforcing the loan contract, unreliable debt service is tolerated, and postponement and rescheduling are in order. In China, soft credit has been reflected in policy loans and banks' passivity in enforcing loan contracts.

1. *Policy Loans*

The negative effects of policy loans have been widely recognized. Government-directed loans have been blamed for the financial crises in Korea and Indonesia.⁹³ It is frequently argued that China's NPL problem results from years of bad lending practices, and is exacerbated by political influences on bank lending or actual policy lending to inefficient, overleveraged SOEs.⁹⁴ The World Bank, for example, has noted with concern that "state banks are not yet completely free to lend according to commercial criteria," as "about a third of their investment lending is allocated to projects selected by the State Planning Commission, and the rest is

92. Anecdotal evidence shows that countries with bank-dominated financial systems, such as Japan and China, are able to sustain high household savings rates, even when real interest rates paid on savings are not very attractive. However, the absence of significant competition from capital markets in such systems typically has led to inefficiency in the allocation of funds and a low rate of return on bank capital. LARDY, *supra* note 20, at 10–11.

93. See, e.g., TOMÁS J.T. BALINO & ANGEL UBIDE, *THE KOREAN FINANCIAL CRISIS OF 1997—A STRATEGY OF FINANCIAL SECTOR REFORM* (IMF Working Paper WP/99/28, Mar. 1999); EDUARDO BORENZTEIN & JONG-WHA LEE, *CREDIT ALLOCATION AND FINANCIAL CRISIS IN KOREA* (IMF Working Paper WP/99/20, Feb. 1999); CRAID P. EHRLICH & JAY K. LEE, *Governance of Korea's Chaebols: Role in Crisis, Coming Changes*, E. ASIAN EXECUTIVE REP. 9 (Mar. 15, 1998); MICHAEL M. PHILLIPS, *One by One: A Look at How the Global Finance Crisis Began*, WALL ST. J. EUR., Apr. 29, 1999, at 12.

94. See, e.g., LARDY, *supra* note 20, at 91–92; DAN ATKINSON, *China Plans Bank Clean-up as Yuan Slides*, THE GUARDIAN (London), Apr. 6, 1999, at 17; and CHINA: ADB: *Chinese Banks Need 5-Year Reprieve Before Liberalization*, Apr. 22, 1999, available at 1999 WL 5618989.

subject to considerable informal government influence, particularly in the provinces."⁹⁵ And "as a result the creditworthiness of borrowers and the commercial viability of projects are often not important considerations in lending decisions."⁹⁶

Lardy defines policy loans in China as loans extended at the behest of the governmental authorities at the central and local level rather than as a result of normal commercial bank decision making.⁹⁷ There are two forms of policy loans in China: policy loans for development purposes and policy loans to subsidize loss-making SOEs.⁹⁸

a. Policy Loans for Development Purposes

Policy loans for development purposes are often referred to as relending in China. The central bank lends to financial institutions, primarily the big four. These funds are earmarked to finance specific projects identified by the State Planning Commission.⁹⁹ These loans are clearly policy loans because they are both directed and financed by the central government.¹⁰⁰

Policy loans for development purposes have developed with the decentralization of financial resources in China. Under the old system of enterprise finance before the economic reform—known as "uniform collection and unified expenditure," enterprises received state budgetary allocations in accordance with the annual economic plan authorized by the State Council. SOEs returned almost all their profits to the MOF and received investment funds plus a minimum amount of quote working capital in the form of grants from the state budget.¹⁰¹ The PBOC, the mono-bank in China before the reform,¹⁰² played a very limited role. The PBOC only provided SOEs with credit to finance above-quote working capital.¹⁰³ Soft budgets to SOEs then seldom took the form of soft credit from banks.

The economic reform initiated in 1978, however, has been changing the picture completely. Accompanying the decentralization of decision-making power through the reforms,¹⁰⁴ an increased proportion of the national financial resources are held by the decentralized units, such as households, enterprises, and local governments. Government savings mobilized though its budget declined during the reform period and their share in total savings dropped from almost 46 percent in 1978 to less than five percent in 1991. The

95. World Bank, *supra* note 44, at 31.

96. *Id.*

97. LARDY, *supra* note 20, at 83.

98. This division has been used before by other authors. See, e.g., Yingyi Qian, *Financial System Reform in China: Lessons from Japan's Main Bank System*, in *THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES* (Masahiko Aoki & Patrick Hude eds., 1994).

99. Now the State Development and Planning Commission.

100. See LARDY, *supra* note 20, at 84.

101. See Bowles, *supra* note 51.

102. Prior to the reforms, financial resources in China were highly centralized. The mobilization and allocation of financial resources was done mainly through the state budget in conjunction with the state plan. Household savings accounted for only three percent whereas the state budget accounted for forty-six percent of total national savings on the eve of the reforms in 1978. Since the government was the main saver and investor, financial intermediaries were neither necessary nor allowed. Hence, financial markets were closed, financial instruments were prohibited, and all financial institutions had been either confiscated or nationalized and were merged with the PBOC. See, e.g., Y.C. JAO, *FINANCIAL REFORM IN CHINA AND HONG KONG 1987-1988: A COMPARATIVE OVERVIEW* (Paper presented to the Inaugural International Conference on Asian Pacific Financial Markets, Nov. 16-18, 1989).

103. See, e.g., Luc De Wulf, *Financial Reform in China*, FIN. & DEV., Dec. 1985, at 19.

104. For a general discussion of the decentralization in China's industrial system, see, e.g., chapters 3 and 4 in JOSEPH C.H. CHAI, *CHINA: TRANSITION TO A MARKET ECONOMY* (1997).

share of savings by decentralized units, however, soared dramatically—by 1991 the share of households in total national savings reached 46 percent. Thus, decentralization of financial resources led to a greater separation of the saver from the investor. As a result, there arose a need for financial intermediaries.¹⁰⁵ After the 1979–84 banking system reconstruction, a two-tier banking system evolved in China: with the PBOC as the first-tier bank and four specialized state banks as the second tier.¹⁰⁶

With more and more financial resources being held by decentralized units, the share of central government revenues of GDP has been decreasing annually.¹⁰⁷ In 1998, the central government revenues were only 12 percent of GDP—well below the developing country average of approximately 32 percent, making it one of the lowest levels in the world.¹⁰⁸ The decline in revenue, combined with the government's desire to keep the budget deficit modest, has brought a similar decline in government expenditures as a share of GDP. Investment suffered the most, falling from 16 percent of GDP in 1978 to less than 3 percent in 1995.¹⁰⁹ As a result, the expansion of the economy relies heavily on the banking system. Starting in 1983, budget financing of working capital for SOEs was drastically curtailed, and in late 1984 the authorities announced that the budget would no longer provide financing for fixed-asset investment.¹¹⁰ In 1995, bank loans accounted for 39 percent of government-controlled investment.¹¹¹

Granting policy loans for development purposes has been legalized as the obligation of state commercial banks since the very beginning of their establishment as specialized state banks. The 1986 Interim Regulations on Bank Administration provide that state specialized banks should lend to enterprises according to state policies and plans.¹¹²

To free state commercial banks from policy loans for development purpose, three policy banks have been established since January 1994: the State Development Bank (SDB), whose general responsibility is for infrastructure lending;¹¹³ the Agricultural Development Bank (ADB), whose responsibility is for funding agricultural procurement and agricultural infrastructure;¹¹⁴ and China Export-Import Bank, whose responsibility is to handle export-

105. See generally World Bank, *World Development Report*, 28–29 (1989).

106. De Wulf, *supra* note 103. For the status of China's financial system at the end of 1985, see figure 1 in Xiaochuan Zhou & Li Zhu, *China's Banking System: Current Status, Perspective on Reform*, 11 J. COMP. ECON. 399 (1987).

107. Between 1978 and 1995, budgetary revenues tumbled from thirty-five percent of GDP to eleven percent. See World Bank, *supra* note 44, at 24.

108. More importantly, sixty percent of RMB 548.3 billion of total central government revenues in 1998 came not from tax collection but from the issuance of debt. Of the debt raised, 70.9% went on to servicing and financing the redemption of other debts. This seriously impairs the central government's ability to pursue a macro-economic policy as well as a fiscal stimulus policy. See, e.g., James Kynge, *China: Poor Revenues Hit Growth Hopes*, FIN. TIMES (London), Apr. 6, 1999.

109. See, e.g., World Bank, *supra* note 44, fig. 3.1.

110. See generally State Council, *Circular of the State Council Approving and Promulgating the Report of the People's Bank of China on PBOC's Unified-Management of State-Operated Enterprises' Working Capital* (June 25, 1983); and Ministry of Finance, *Interim Provisions Converting All State Budgetary Capital Construction Investment from Appropriations to Loans* (Dec. 14, 1984).

111. See World Bank, *supra* note 44, fig. 3.2.

112. See State Council, *Interim Regulations of the People's Republic of China on Bank Administration*, art. 14 (Jan. 7, 1986) [hereinafter *Interim Regulations on Bank Administration*].

113. See Circular of the State Council on Establishing State Development Bank No. 22 (1994).

114. See Circular of the State Council on Establishing China Agricultural Development Bank No. 25 (1994).

import financing for key sectors.¹¹⁵ It was expected that all government-directed investments outside the budget would be financed through the policy banks. The establishment of the four policy banks has to some extent released the big four banks of their policy-lending obligation, as reflected in changes in the magnitude of central bank loans to the big four. Central bank lending to the big four grew from RMB 268.2 billion in 1985 to over RMB 960 billion by 1993 and then fell to RMB 680 billion at year-end 1995 as policy lending began to be channeled through newly created policy banks in 1994.¹¹⁶ The policy banks, however, generally lack secure funding sources. For example, most of the SDB's funding has come from low-interest bonds placed with state banks by PBOC fiat, while the ADB relies on PBOC relending for 90 percent of its needs.¹¹⁷ Another weakness of policy banks is their lack of branches.¹¹⁸ They have to rely in varying degrees on designated institutional proxies. Furthermore, policy banks, because of their mandates to lend to state projects, and for the implementation of state policies, are accumulating NPLs themselves. The ADB, for example, had accumulated RMB 214 billion NPLs from its establishment to November 1999.¹¹⁹

These institutional weaknesses with young policy banks indicate that it may take a while before they have the resources to shoulder all policy lending. As a result, state commercial banks are still required to conduct their loan business in accordance with the need for the development of the national economy and social progress as well as under the guidance of the state industrial policy.¹²⁰

b. Policy Loans to Subsidize Loss-Making Enterprises

The situation of policy loans to subsidize loss-making enterprises is more complicated than policy loans for development purposes. China's SOEs, while acquiring increased autonomy over their operations since 1980,¹²¹ are increasingly under pressures from competition created by trade liberalization and the proliferation of nonstate enterprises, and consequently suffer huge losses every year.¹²² Their rate of return on assets (measured by pre-tax

115. The Export-Import Bank of China was formally established on April 26, 1994, and began operating on July 1, 1994. The bank's financial business is subject to the direction and supervision of the MOF, the MOFTEC, and the PBOC. See TIMOTHY HAOSAN WAN, *DEVELOPMENT OF BANKING LAW IN THE GREAT CHINA AREA: PRC AND TAIWAN* 181-82 (1999).

116. See LARDY, *supra* note 20, at 85.

117. See generally William D. Holmes, *China's Financial Reforms in the Global Market*, 28 *LAW & POL'Y INT'L BUS.* 715 (1997).

118. It was reported that twenty regional branches of the former China Investment Bank, a state-run commercial bank that funds major infrastructure projects across China, have been transferred to the SDB, adding to the SDB's own thirty branches. See, e.g., *China's State Development Bank Adds 20 New Commercial Branches*, Mar. 18, 1999, at <http://www.chinaonline.com>.

119. See, e.g., *China: China's WTO Deal Heralds Radical Banking Reform*, REUTERS ENGLISH NEWS SERVICE, Nov. 16, 1999. The ADB funds state grain purchases from farmers at above-market prices. It was estimated that the amount would rise dramatically as cheaper and better foreign agricultural imports flooded the market. *Id.*

120. See Commercial Banking Law of the People's Republic of China, decree 47, art. 34 (May 10, 1995) (PRC).

121. For a detailed discussion of the SOEs' increasing autonomy through the economic reform, see CHAI, *supra* note 104, ch. 4.

122. Compared to non-state sector enterprises, SOEs have lagged in output, employment, and productivity growth. Their return on assets is estimated at just 6.0%, compared with 8.4% in collectives, and 9.9% in joint ventures. Their share of loss-makers was twenty-six percent in 1992 and increased to fifty percent in 1996. See World Bank, *supra* note 44, at 28.

profits divided by the sum of the depreciated value of fixed assets plus working capital) has been declining during the economic reform, which averaged twenty-four to 25 percent in the early years of reform, and has declined continuously since 1985 while staying at only 6 percent in 1997.¹²³ As a result, the SOEs' dependence on public subsidies began to increase.¹²⁴ The decentralized financial resources, however, made the government unable and unwilling to subsidize these enterprises by budget.¹²⁵ Thus, the state banking system became the SOEs' main source of financial support.¹²⁶

Some of the subsidizing policy loans are actually subsidies to enterprises that are suffering losses because of government policies and the cost of their social security benefits.¹²⁷ After the decentralization of finance resources, the task of subsidizing those enterprises shifted from the government budget to banks. Banks are required to lend to subsidize loss-making enterprises.¹²⁸

To contract the scope of subsidies, at the 14th Session of the 8th NPC in March 1996, the government announced its intention to concentrate on the reform and development of 1,000 large SOEs and state-owned enterprise groups that would form the core of China's modern enterprise system. At the same time, the government would loosen controls on the operations of China's roughly 90,000 small industrial SOEs.¹²⁹ The central government also determined that continued policy loans, tax relief, additional credit, and sales support would be used to support these 1,000 core enterprises and enterprise groups, while the rest of the SOEs would be left for restructuring, mergers, leasing, and sale to nonstate enterprises or bankruptcy.¹³⁰ Consequently, the state commercial banks' lending mission was narrowed to a small population of eligible SOEs by the adoption of the main bank system. Adopting the Japanese model, each borrower is paired with a main bank lender—actually a designated bank branch—with which it keeps its basic account and from which it receives all of its loans (unless the main bank is unable to meet its demand). Three hundred core large- and medium-sized SOEs were paired with main banks as the first step to adopting the main bank system.¹³¹ As a result, 80 percent of new loans went to these 300 SOEs in the first half of 1996.¹³²

In addition to policy loans subsidizing enterprises suffering losses because of government policy, there are also loans made under informal government intervention. Banks are forced

123. See, e.g., LARDY, *supra* note 22, at 17–18.

124. Since the late 1980s, direct fiscal subsidies and indirect subsidies (policy loans) combined to at least ten percent or more of GDP every year. See LARDY, *supra* note 20, at 4.

125. For example, budgetary subsidies fell from 7.5% of GDP in 1992 to 2.3% in 1994. See *The Chinese Economy: Fighting Inflation, Deepening Reforms*, in WORLD BANK COUNTRY SURVEY 17 (1996).

126. Despite recent attempts to reform, China's banks are still the dispensers of disguised subsidies, in the form of loans, to unprofitable SOEs. In 1994, for example, implicit financial subsidies in the form of low-interest-rate loans and unpaid principal and interest came to 1.7% of GDP. *Id.*

127. For example, in 1994, a survey of 156 SOEs shows that the budgetary and financial subsidies received costs equal to enterprises arising from government price policies, social securities benefits, and wages for redundant workers. *Id.*

128. In 1994, for example, the PBOC issued an urgent circular requiring state commercial banks to lend to "hopeless," loss-making SOEs, so as to maintain the life of those SOEs' employees and the stability of the society. See PBOC, Urgent Circular on Making Working Capital Loans to SOEs No. 34 (1994).

129. LARDY, *supra* note 20; and World Bank, *supra* note 44, at 29–30.

130. See, e.g., Sheryl Miller, *Institutional Impediments to the Enforcement of China's Bankruptcy Laws*, 8 INT'L LEGAL PERSP. 187 (1996).

131. This system is set out in PBOC, *The Provisional Measures for Main Bank Management* (June 29, 1996).

132. Holmes, *supra* note 117.

to make subsidizing loans to SOEs outside the 1,000 core enterprises. Enterprises outside the 1,000 core enterprises or enterprise groups are mainly SOEs subject to local governments. Local governments at various levels, especially provincial governments, fearing a large layoff from the failure of loss-making enterprises, have pressured state banks to keep lending to loss-making enterprises. And they were well positioned to make interventions because the PBOC and the big four have thousands of regional and local branch offices that were under dual administration by headquarters and the regional or local governments.¹³³ Under such an administrative structure, even if the commercial bank law granted banking institutions autonomy to make lending decisions and prohibit any individual or entity from forcing the bank to make lending or provide a guarantee,¹³⁴ their full autonomy cannot be guaranteed.¹³⁵ According to Moody, in the first half of 1999, 89 percent of state bank lending was to state-sector companies in spite of their poor performance.¹³⁶

To curb the intervention from local government, the PBOC has recently reformed its institutional structure. It has abolished its branches at provincial and municipal levels, under which banks were vulnerable to local government intervention, and established trans-provincial branches in nine major regions, along the line of the U.S. Federal Reserve System.¹³⁷ It is expected that this institutional change can increase central bank power in pursuing monetary policies, increase its independence in supervising financial institutions, punish people who break the law, and improve its efficiency. The state commercial banks have been reforming their institutional structure and concentrated lending discretion.¹³⁸ Moreover, the Central Committee of the Chinese Communist Party and the State Council have established a high-level, joint party government Financial Working Committee to oversee China's financial sector.¹³⁹ It was reported¹⁴⁰ that the establishment of the Working

133. China's central bank was an immense institution with branches in every provincial level administrative unit and offices in all the larger cities as well as most counties before the 1998 structural reshuffle. By mid-1993, the provincial branches of the PBOC responded primarily to provincial level political leaders rather than central bank headquarters in Beijing. This was not surprising since the control of appointments of the top officials in each provincial branch of the central bank was largely in the hands of provincial party officials rather than in the hands of the central bank headquarters in Beijing. In turn, the provincial branches of the four specialized banks, to a lesser degree than other banks, were responsive primarily to the policies emanating from the provincial branches of the central bank rather than their own head offices in Beijing. This structure maximized the possibility that loan decisions within each province would be responsive to local political pressure and even corruption. See LARDY, *supra* note 20, at 90–91.

134. *Interim Regulations on Bank Administration*, *supra* note 112; Commercial Banking Law, art. 41; and General Lending Rules, art. 22 (Aug. 1, 1996) (provides lender's right) [hereinafter General Lending Rules].

135. This is indicated in one signed article by an official with the headquarters of CCB published in *Zhongguo Jingrong* (China Finance), a journal published monthly by the PBOC, where the author suggests that regional and local branches should avoid and resist making policy loans imposed by local governments with flexible strategy and tactics and try to win over their understanding and support. See Bo Song, *Proposals on the Commercial Bank's NPL Workout*, 1 CHINA FIN. (Beijing) 23 (1998).

136. See, e.g., James Kynge, *Beijing: China Bank Reform "Yet to Tackle All Faults,"* FIN. TIMES (London), Aug. 18, 1999.

137. See, e.g., *Financial System Reform to Move into New Stages*, XINHUA NEWS AGENCY, Apr. 2, 1999, available at 1999 WL 7302553. For the evolution of PBOC's regional branch system, see *Evolution of China's Central Bank Regional Branch System*, Jan. 27, 1999, at <http://www.chinaonline.com>.

138. See, e.g., *CCB Is Enjoying a Rapid Development and Undertaking a Strategic Reform*, 8 CHINA FIN. (Beijing) 9 (1998); *The Reform of SOEs and the ICBC*, 1 CHINA FIN. (Beijing) 8 (1998); and *ABC Pressing Forward in China's Reform and Opening up*, 8 CHINA FIN. (Beijing) 4 (1998).

139. "The Committee is headed by Wen Jiabao, Politburo member and Vice Premier." *China Establishes High-Level Banking Oversight Committee*, June 23, 1998, at <http://www.chinaonline.com>.

140. *Id.*

Committee was intended (1) to make China's banking system independent of regional and local political leadership and (2) to end widespread corruption among banking officials. Whether these institutional reforms can insulate state commercial banks from local government intervention, however, remains to be tested.¹⁴¹ Given the complexity of the problem, it might be safe to conclude that policy loans to subsidize loss-making SOEs will not disappear in the near future. Dai Xianglong, the PBOC governor, announced at the World Economic Forum in Beijing in April 1999 that the big four would end policy loans to bail out government businesses within two years.¹⁴² This might be a realistic commitment.

2. *Creditor Passivity of Banks*

Soft credit does not only mean that banks lend to SOEs without careful credit analysis, but also denotes that creditors involuntarily or voluntarily tolerate their debtors' default.¹⁴³ This kind of phenomenon was termed "creditor passivity of banks" by David Begg and Richard Portes in their 1993 paper on enterprise debt and financial restructuring in Central and Eastern Europe.¹⁴⁴

a. *Creditor Passivity of Banks in China*

The creditor passivity of banks is pervasive in China. When enterprise debtors fail to pay loan principal and interest on time, instead of enforcing the loan contract against defaulting debtors, foreclosing on the collateral, filing a bankruptcy case as the last resort, or seeking debt-restructuring arrangements, banks often choose to simply reschedule or roll over the debtors' loans.¹⁴⁵ Although the Enterprise Bankruptcy Law¹⁴⁶ has been in effect since November 1, 1988, three months after the law on SOEs¹⁴⁷ became effective, only a few enterprises went bankrupt.¹⁴⁸ Furthermore, among all the bankruptcy cases, only a handful of them were initiated by banks. For example, in 1994, among all the bankruptcy cases filed with the court, only 1.7 percent of them were initiated by banks, 1.6 percent in 1995,¹⁴⁹

141. It is noted by Davin Mackenzie, the International Finance Corporation Chief Representative in China, "that now local governments no long decide who should be appointed as senior officials of the banks' local branches; [and] as a result . . . the banks are reporting less administrative intervention in their lending activities." *China's Banking Reform Yields Results: IFC Official*, XINHUA NEWS AGENCY, May 14, 1999, available at 1999 WL 7303805.

142. Rowan Callick, *China Draws Near to WTO Membership*, AUSTL. FIN. REV., Apr. 28, 1999, at 15.

143. See KORNAL, *supra* note 46, at 118, 123; and KORNAL, *supra* note 47, at 132.

144. See generally David Begg & Richard Portes, *Enterprise Debt and Financial Restructuring in Central and Eastern Europe*, 37 EUR. ECON. REV. 396 (1993).

145. See, e.g., Wuyi Wang, *Analyzing Factors Influencing the Bankruptcies of China's State-Owned Enterprises*, JINGJI YANJIU (Beijing), June 20, 1994, at 41.

146. Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation) (Nov. 1, 1988) [hereinafter Enterprise Bankruptcy Law]. This law applies only to SOEs. For an English translation, see Douglas G. Boshkoff & Yongxin Song, *China's New Bankruptcy Law: A Translation and Brief Introduction*, 61 AM. BANKR. L.J. 359 (1987).

147. The Law of the People's Republic of China on State-Owned Industrial Enterprises (Aug. 1, 1988).

148. According to unofficial statistics, the Chinese court accepted more than 11,600 bankruptcy cases from the effective date of the Enterprise Bankruptcy Law to mid-1997. Among them, the majority were non-SOE enterprises. Furthermore, of those bankrupt SOEs, the majority are small enterprises with fewer than 1,000 employees. Miller, *supra* note 130.

149. POLICIES AND PROCEDURES FOR ASSET RESTRUCTURING, *supra* note 1, at 209-10. In 1995, only forty-seven of 2,385 bankruptcies were initiated by banks. See Jane Macartney, *China Sharply Accelerates Bankruptcies in 1996*, REUTERS NEWS SERVICE, Jan. 28, 1997.

and 1.15 percent in 1996.¹⁵⁰ As an adjunct to banks' reluctance in directing an enterprise into bankruptcy, the banks also become unwilling and sometimes strongly adverse participants in reorganization or compromise proposals.¹⁵¹ Making matters worse, banks are often required by the government to subsidize enterprise reorganization. For example, to encourage acquisitions of weak industrial SOEs by healthy SOEs, banks are required to exempt or suspend the interest repayment of the loans to acquired SOEs.¹⁵²

b. Causes of Creditor Passivity of Banks in China

Janet Mitchell discusses causes of "creditor's passivity" using Hungarian experiences.¹⁵³ First, banks may not initiate bankruptcy proceedings because the expected value of the debtor's assets is less than the costs of enforcing bankruptcy, or because there is an option value in waiting. In the former case, there is no incentive for new lending, whereas the latter may justify rescheduling debt; a sufficiently favorable outcome may work wonders for existing, non-performing debt. Second, taking action against debtors may signal the extent of the bank's NPLs. In China, a run on state commercial banks is unlikely because of implicit government guarantee, but the bank may nevertheless be reluctant to signal its problems to regulatory authorities and the public. Third, there may be free rider problems when there are multiple creditors. If each bank foresees that a government bailout will become necessary because other creditors take no action, such an expectation may become self-fulfilling.

In China, in addition to these normal causes, several factors can be identified as causes of the passivity of banks in collecting loans. There are disincentive factors within and outside the banking system. The disincentive factors outside the banking system include the reluctance of the government to allow insolvent SOEs to file bankruptcy, weakness in the court system, the lack of an adequate social welfare system, regionalism, the short history of bankruptcy law in PRC, and so on.¹⁵⁴ A PBOC survey found problems such as bankruptcy practices not being standardized, eroding of creditors' interests, and certain policies and regulations failing to match bankruptcy practice.¹⁵⁵ In the rest of this section, the author will mainly discuss the problems with China's bankruptcy and banking legislation.

c. The Disincentives: Factors Within China's Banking Law

While the bank soft credits are now the main source of soft budget constraints on SOEs,¹⁵⁶ the general budget constraints on China's state commercial banks remain soft as well. Despite the provisions of the Commercial Bank Law,¹⁵⁶ state commercial banks in China are not operating independently and hence cannot assume their civil responsibilities indepen-

150. In 1996, only seventy-two of 6,232 bankruptcies were initiated by banks. Macartney, *supra* note 149.

151. See, e.g., Ronald Winston Harner, *Insolvency Law and Reform in the People's Republic of China*, 64 *FORDHAM L. REV.* 2563 (1996).

152. See PBOC, SETC, and MOF, Circular on How to Deal with Bank Principles and Interests of Loans to Weak Industrial SOEs in 18 Pilot Cities When They Are Acquired by Healthy SOEs (May 4, 1995).

153. Janet Mitchell, *Creditor Passivity and Bankruptcy: Implications for Economic Reform*, in *CAPITAL MARKETS AND FINANCIAL INTERMEDIATION* (Colin Mayer & Xavier Vives eds., 1993).

154. For a detailed discussion of these issues, see generally Miller, *supra* note 130; Harner, *supra* note 151; and Mark E. Monfort, *Reform of the State-Owned Enterprises and the Bankruptcy Law in the People's Republic of China*, 22 *OKLA. CITY U.L. REV.* 1067 (1997).

155. See *Central Bank Cites Impact of Bankruptcies*, CHINA NEWS AGENCY, DEC. 18, 1995.

156. Article 4 of the Commercial Banking Law provides that a commercial bank shall operate independently—free from interference by any department and individual—assume civil responsibilities independently with its entire assets as a body corporate—take up responsibility for all risks it may encounter and for its own profits and losses it may bear.

dently.¹⁵⁷ First, as previously mentioned, a significant proportion of their lending remains policy loans or loans conducted under informal government intervention; therefore, they have to extend loans to SOEs regardless of their creditworthiness. This, together with the various administrative controls on commercial banks, makes it difficult to hold banks responsible for their own profits and losses. Second, because of their state ownership and the "too big to fail" logic, state commercial banks can always expect government bailout.

In addition to soft budget constraints, inadequate loan classification and provisioning rules also create disincentives for Chinese banks to act positively against their delinquent borrowers. In China, the main indices in the assessment of a bank's business volume are the balances of deposits and loans, interest receipts, and, closely related to the interest income, the bank's profits. Outstanding loans after liquidation when the borrower and its guarantor go bankrupt would be classified as irrecoverable loans¹⁵⁸ and thus affect the banks' official evaluation. It is therefore understandable that bank managers, especially managers of state commercial banks, would like to keep their borrowers afloat.

Moreover, unlike banks in most developed countries, which usually maintain adequate reserves for bad debts, Chinese banks have maintained a very low ratio of NPL provisions to total assets. The big four only started to provide for irrecoverable loans in 1988 at fixed percentages to their outstanding loans at the beginning of the year and the percentages ceiled the reserves.¹⁵⁹ In 1992, the ceiling was increased to 1 percent of the total outstanding loans at the beginning of the year,¹⁶⁰ and further increased to 1 percent of the year-end outstanding loans from 1998 on.¹⁶¹ Extra provisions are not tax deductible.

Making matters worse, Chinese banks do not have enough autonomy to write off NPLs. Before 1988, the big four were not allowed to write off any bad loans without specific approval from the State Council. After the implementation of the Enterprise Bankruptcy Law in 1988, a handful of firms were liquidated each year, but the banks still had little autonomy to write off loans they had extended to liquidated enterprises. Banks must get approval from local PBOC branches, provincial PBOC branches, or even the State Council.¹⁶² The result appears to be that banks are required to keep on their books many loans to liquidated borrowers.¹⁶³

• 157. One banking law drafter observed it would take "a period of time for the banking institutions to meet all the new banking laws' requirements." James Harding, *China Passes New Banking Law*, FIN. TIMES (London), May 12, 1995.

158. See Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves, art. 3 (Jan. 1, 1988) (PRC) [hereinafter Irrecoverable Loan Reserves].

159. The percentages required were quite low: 0.1% for working capital loans to industrial production enterprises, commercial enterprises, and construction enterprises; 0.2% for loans to the agricultural sector, urban and township collective enterprises, and private enterprises and individual proprietors; 0.15% for export & import loans; 0.2% for foreign exchange loans, loans for fixed assets, and loans for updating technology. No reserves were allowed to provide for loans substituting budgetary grants, special-purpose loans trusted by local governments and authorities in charge of the enterprise, loans secured with collateral, and interfinancial institution loans. Irrecoverable Loan Reserves, arts. 5-7.

160. The ceiling for 1993 was set at 0.5%. Banks were required to increase their reserves 0.1% annually from the previous year until their reserves reached one percent of their total outstanding loans at the beginning of the year. See Ministry of Finance, Circular Revising Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves, art. 2 (Jan. 1, 1992).

162. See WORLD BANK, CHINA: FINANCIAL SECTOR POLICIES AND INSTITUTIONAL DEVELOPMENT 94-95 (1990).

161. See Circular of the Ministry of Finance on the Non-Accrual Loans and Loan Loss Provisions, CHENGSHI JINRONG Bao (July 21, 1998).

163. In 1994, for example, branches of ICBC, CCB, ABC, BOC, and BOCOM applied together to write off RMB 474 million of irrecoverable loans; only RMB 4.172 million got the approval for the write-off.

d. The Problem with the Bankruptcy Proceedings

China's current Enterprise Bankruptcy Law, adopted in 1986, is a very brief statute, with only forty-three articles. The bankruptcy proceedings under this law impede creditors from initiating a bankruptcy case against their debtor enterprises.

Under the Enterprise Bankruptcy Law, SOEs may be placed in bankruptcy proceedings when they have "suffered serious losses and cannot pay [their] debts because of poor management."¹⁶⁴ This qualifies the right of creditors to force involuntary proceedings by requiring proof that the businesses' losses are due to poor operation and management. Theoretically, businesses whose losses could not be anticipated and prevented are outside the bankruptcy net, even though they are deeply in debt. Creditors are also prohibited from filing bankruptcy cases against public utilities and enterprises of major concern to the national economy and the general welfare of the public whose debts are to be repaid by government subsidies or through other arrangements with appropriate governmental departments.¹⁶⁵ Although the burden of proof on creditors was mitigated to some extent by the People's Supreme Court Opinions of 1991,¹⁶⁶ given the difficulties in identifying the financial state of an enterprise due to underdeveloped accounting and disclosure practices in China,¹⁶⁷ it is still not an easy job for a creditor to make the decision to initiate a bankruptcy case.

Even if the creditor succeeds in building up evidence and filing a bankruptcy case against its debtor, the bankruptcy proceeding is still subject to various government interventions.¹⁶⁸

164. Enterprise Bankruptcy Law, art. 3.

165. *Id.*

166. Supreme People's Court, *Opinions of the Supreme People's Court on Issues Concerning the Implementation of the Law of Bankruptcy for Enterprises of the People's Republic of China* (Nov. 7, 1991) [hereinafter *Bankruptcy Law Opinions*]. By then it had been recognized that the skeleton nature of the Bankruptcy Law required some considerable detail regarding practice and procedure. The Opinions sought to provide such details. With regard to article 3 of the Enterprise Bankruptcy Law, the Opinions stated that an inability to discharge matured liabilities meant that the time for discharge or payment of such debt (or debts) had expired, a creditor had demanded payment, and the debtor was obviously deficient in liquidity. Bankruptcy Law Opinions, art. 8. Article 8 of the Opinions also provided that a debtor should be deemed incapable of discharging matured debts if it ceased repaying debts continuously. These provisions, together with the provisions that a creditor need only prove its claims against the debtor and the debtor's incapability of repaying the debt due when it files bankruptcy against the debtor (article 2 of the Opinions), have obviously mitigated the creditor's burden of proof in filing a bankruptcy case against its debtor.

167. All insolvency laws relate to the financial position of an enterprise; the early identification of the financial situation of an enterprise is vital to the implementation of modern insolvency techniques of reorganization or reconstruction. Also, the maintenance of full and proper accounts avoids time and costs in a liquidation procedure. Only with the assistance of a modern accounting system may the financial position of an enterprise be fairly ascertained. Because of the long period of command economy, when accounting mechanisms were geared to provide basic cost and production information, it was not until mid-1993 that China began to adopt recognized and accepted international accounting techniques and standards. The accounting and disclosure practices remain poor in China. In addition to the poor accounting and disclosure practices, there are other obstacles in determining a SOE's real financial situation, including soft budget constraints, government intervention, and a great number of social burdens on SOEs. These factors make it difficult to properly assess SOE performance. See Monfort, *supra* note 154.

168. The Enterprise Bankruptcy Law is filled with references to discretionary actions by government authorities. Government authorities are involved in the composition and reorganization of the insolvent enterprise (under article 17 of the Enterprise Bankruptcy Law, if the bankruptcy procedure is instituted by creditors of the insolvent enterprise, the government authority in charge of the insolvent enterprise can apply for the

The enterprise bankruptcy will almost inevitably involve such government agencies as the auditing authority, the administration for industry and commerce, the revenue authority, the price-control authority, the civil administration department, the land administration, the labor and personnel department, the social insurance authority, and others. Actually, in most circumstances, the court will have to seek the collaboration from the relevant government authorities in dealing with the insolvent enterprise. Sometimes, the court cannot even declare the bankruptcy of an insolvent enterprise without the collaboration of all the relevant government authorities.¹⁶⁹

The extensive government involvement makes the bankruptcy case unattractive to banks. In addition to the usual difficulties associated with multiple decision makers, it also results, in many cases, in a lengthy decision-making process, while an insolvency law that is proactive cannot be expected to provide benefits unless the process is permitted to operate quickly and efficiently, before the financial difficulties become acute and critical.

e. The Pro-employee Asset Distribution

According to article 37 of the Enterprise Bankruptcy Law, the assets of the bankruptcy estate will not go to the unsecured creditor before salaries and labor insurance benefits owed by the debtor are given to its workers and staff, and then the taxation obligation of the debtor is satisfied.¹⁷⁰ A circular issued by the State Council in 1994 reiterates the bias in favor of employees. According to that circular, the first priority in a case of enterprise bankruptcy is to "resettle the employees in order to maintain order and stability in the society."¹⁷¹ The circular provides that proceeds from the sale of land use rights (usually the most valuable property of the insolvent enterprise) shall first be used to resettle the employees of the enterprise before it can be included in the bankruptcy estate for distribution;¹⁷² if the proceeds from the sale of the land use right cannot satisfy the resettlement

reorganization of the insolvent enterprise no later than three months after the court's acceptance of the creditors' application. Article 20 of the Enterprise Bankruptcy Law authorizes the government authority in charge of the insolvent enterprise to manage the reorganization of the enterprise after the composition agreement has been reached between the insolvent enterprise and its creditors), the liquidation of the bankrupt enterprise (in accordance with article 24 of the Enterprise Bankruptcy Law, the People's Court should appoint a liquidation commission formed by the government authority in charge of the bankrupt enterprise, the government fiscal organ, and professionals within fifteen days after the declaration of the bankruptcy), the settlement of the redundant employees of the bankrupt enterprise and their welfare before reemployment (article 4 of the Enterprise Bankruptcy Law provides that the government should settle down the redundant employees of the bankrupt enterprise through various means, arrange for their reemployment, and ensure their life before reemployment), and the investigation of the liability for the bankruptcy of the enterprise (article 42 of the Enterprise Bankruptcy Law authorizes this to the government's supervisory authority and auditing authority).

169. See Wang Zheng, *Going Bankrupt in Accordance with the Law—Practices in Shenyang*, PEOPLE'S DAILY, Nov. 18, 1996. The dominant role of government in enterprise bankruptcy is clearly evidenced by the bankruptcy of the Achen Sugar Mill. The plant in Heilongjiang province was established in 1905 and used to be one of the largest sugar mills in China. Because of poor management and heavy debt burdens, the enterprise stopped production in 1993. At the end of 1997, the enterprise had assets worth only RMB 280 billion, while its debts (principal and interest) accumulated to RMB 700 billion. The company, however, was only able to apply for bankruptcy in June 1998 after the approval of the relevant government authorities. See Chen Kaixing, *The Bankruptcy of Achen Sugar Mill Goes to Its Last Stage [Achen Tangchang Pochan An Jingru Zhongjie Jieduan]*, PEOPLE'S DAILY (Overseas Ed.), Nov. 12, 1998, at 1.

170. Enterprise Bankruptcy Law, art. 37.

171. State Council, Circular on the Trial of Bankruptcy of State-Owned Enterprises in Several Pilot Cities, art. 1 (Oct. 25, 1994) [hereinafter 1994 Circular].

172. *Id.* art. 2.

requirements, other assets in the bankruptcy estate should be used for resettlement purposes.¹⁷³ Likewise, the housing, schools, nurseries, hospitals, and other welfare facilities of the bankrupt enterprise will no longer be the property of the bankrupt enterprise, but rather will be administrated by the relevant government department, with their employees to be taken in or resettled by the unit that takes over the particular facility.¹⁷⁴ In 1997, the State Council promulgated the Supplementary Notice on Issues Concerning the Trial Implementation in Several Cities of State-Owned Enterprise Bankruptcy and Merger and Re-employment of Staff and Workers.¹⁷⁵ It creates fundamental changes in the rights of creditors (both secured and unsecured) provided by the Civil Procedure Law,¹⁷⁶ the Security Law,¹⁷⁷ and the Enterprise Bankruptcy Law,¹⁷⁸ stripping them of their expectancy in a search for funds to pay for the resettlement and reemployment of employees of bankrupt SOEs. Creditors of bankrupt enterprises covered by the 1997 Notice—state-owned industrial enterprises in what are now the 111 cities¹⁷⁹ in the State Council's Capital Structure Optimization Program for enterprises—are now to be paid only out of assets remaining after the costs of resettlement have been met.¹⁸⁰ Like the 1994 Circular, the 1997 Notice provides that the cost of the resettlement of employees shall be paid for first by revenues from the disposition of land use rights.¹⁸¹ The 1997 Notice, however, goes further to specifically state where land use rights that have been encumbered with security interests are also to be used for funding resettlement costs before any of the income from their dispositions is used to pay off secured creditors.¹⁸² These provisions have seriously reduced the amount of bankruptcy estate available for creditors. As a result, banks become the largest loser in enterprise bankruptcy. In the Achen Sugar Mill bankruptcy case, for example, after liquidation, the bankrupt enterprise had assets equal to RMB 120 million. All of its assets were used to compensate its 4,500 workers, the cost of which was estimated at RMB 130 million. All loan principal and interest, which equaled to RMB 700 million, was written off.¹⁸³

3. *Policy Loans and Creditor Passivity of Banks: Bailout Expectation and Borrower's Irresponsiveness to Market Signals*

As mentioned in Section III, no bailout expectation and borrowers' responsiveness to market signals are prerequisites to market discipline. These two conditions are hampered in China by policy loans and banks' passivity in enforcing loan contracts.

173. *Id.* art. 3.

174. *Id.*

175. State Council, The Supplementary Notice on Issues Concerning the Trial Implementation in Several Cities of State-Owned Enterprise Bankruptcy and Merger and Re-employment of Staff and Workers (Mar. 2, 1997) [hereinafter 1997 Notice].

176. Civil Procedure Law, art. 203–04.

177. Security Law of the People's Republic of China, art. 33 (June 30, 1995) [hereinafter Security Law].

178. Enterprise Bankruptcy Law, art. 32.

179. The relevant cities are listed in an appendix to the 1997 Notice and include Beijing, Changchun, Changsha, Chengdu, Chongqing, Dalian, Fuzhou, Guangzhou, Haikou, Harbin, Jilin, Nanjing, Ningbo, Qingdao, Shanghai, Shenyang, Shenzhen, Tianjin, Wuhan, Xiamen, and Wuxi.

180. See Donald C. Clark, *State Council Notice Nullifies Statutory Rights of Creditors*, 19 E. ASIAN EXECUTIVE REP. 9, 9 (Apr. 15, 1997).

181. 1997 Notice, *supra* note 175, art. 5.

182. *Id.*

183. Kaixing, *supra* note 169.

a. Failure of Market Discipline Due to Policy Loans

As a kind of soft budget constraint to SOEs, policy loans result in SOEs' irresponsiveness to market signals¹⁸⁴ and lack of dynamic capacity. To make matters worse, because banks are subject to government mandate and intervention in their lending activities, the need for the development of the micro-credit analysis structure in the banking industry has been delayed and masked—resulting in weak internal control systems, especially risk-control systems within state commercial banks. All these lead to the failure of market discipline in preventing unsustainable borrowing in China and consequently result in the accumulation of NPLs on state commercial banks' books.

b. Budget Constraints Cannot Be Hardened without Positive Bank Creditors

The passive attitude of bank creditors towards SOEs has further softened the enterprise budget constraints. Despite various efforts to harden budget constraint on SOEs, without pushing insolvent SOEs into bankruptcy, however, budget constraints cannot be really hardened and there will be no real financial discipline.¹⁸⁵ To make matters worse, as a result of passivity, banks, especially state banks in China, become more and more exposed to loss-making SOEs. This means that they are more vulnerable to the collapse of enterprise, and make them more passive in enforcing their credit.

C. ADMINISTRATIVE CONTROLS ON STATE COMMERCIAL BANKS:

CREDIT PLAN AND INTEREST RATE CONTROL

1. *Administrative Controls on State Commercial Banks as Instruments to Implement Monetary Policy*

China's bank-centric finance has determined that the bank must play an important role in accumulating and distributing funds. This, together with the central bank's inability to use indirect instruments to implement monetary policy, result in administrative controls on

184. According to a survey in 1992, enterprises' demands for bank loans were not very responsive to changes in interest rates. CHAI, *supra* note 104, table 5.3. The inelastic demand was partly due to the fact that enterprises were not yet fully responsible for their profits and losses. It was also due to the practice whereby, until very recently, enterprises were allowed to deduct from their pre-tax profits both the cost of interest and the repayment of the principal of their loans. This practice lowered the cost to enterprises of borrowing and reduced the interest rate elasticity of demand for bank loans. *Id.* at 129.

185. Efforts in China and other formerly planned countries, at least in the very beginning of their reform, were mainly made to increase the profit incentives within state-owned enterprises. Hardness of the budget constraint, however, is not a synonym for profit maximizing. Profit maximizing refers to the internal goal setting of the decision maker in the firm; the softness-hardness of the budget constraint refers to the external tolerance limits to losses. A profit-maximizing firm, if it is in the red, will try to cut its losses. A hard-budget constraint means that even if the firm tries hard to cut its losses, the environment will not tolerate a protracted deficit. The emphasis is on punishment. In this sense, making a state-owned enterprise an independent legal person accounting for its own profits and losses does not mean that the budget constraint has been really hardened. Only when the persistent loss is a matter of life and death can we say that there is a hard budget constraint on state-owned enterprises in China. In other words, the fact that managers and workers of a state-owned firm are interested in increasing profits does not in itself determine their behavior. Only if profit incentives are combined with a hard budget constraint will efforts be directed towards the line of real actions.

186. "As Ziyang Zhao, China's former premier minister, pointed out in his report of the Seventh Five Year Plan, the function of banks in macroeconomic management should be significantly reinforced." Hongru, *supra* note 70, at 332.

In his report to the thirteenth National Congress of the Chinese Communist Party, Zhao, Ziyang again emphasized that we should intensify the reform of China's monetary system, strengthen the

commercial banks such as credit plans, interest rate controls, etc.,¹⁸⁶ although these direct instruments have not always proven very effective.¹⁸⁷

The overreliance on direct monetary instruments evolved from the pre-reform period. From 1953 to 1978, the state controlled the supply of credit and cash through a credit and cash plan.¹⁸⁸ The credit plan was to provide working capital for industry and commerce, while the cash plan was designed to control demand and to facilitate transactions in consumer goods markets.¹⁸⁹ The PBOC followed cash and credit plans from the State Planning Commission, and its branches provided financial resources to enterprises according to the plan.

In 1978, the PBOC was separated from the Ministry of Finance (MOF) and granted ministerial rank.¹⁹⁰ Five years later, in 1983, the State Council granted the PBOC the authority of a central bank and the PBOC subsequently transferred its commercial operations to four specialized banks.¹⁹¹ The decisions authorized the PBOC to take responsibility for making and implementing monetary policy via credit plans and interest rate control, among other means.¹⁹² The PBOC therefore continued to operate through the familiar and proven administrative controls of the centrally planned economy, setting limits on prices (interest rates) and quantities (credit) to pursue its dual objectives of directing credit while maintaining macro-economic control.¹⁹³ The PBOC's responsibilities of formulating and implementing a credit plan and controlling deposit and loan interest rates were confirmed in the 1986 Interim Regulations on Bank Administration.¹⁹⁴

Under the general theme of establishing a "socialist market economy with Chinese characteristics," the State Council issued the Resolution on Financial Reform in 1993,¹⁹⁵ calling for more reliance on indirect monetary policy instruments. The Resolution, however, retained the credit plan as one of the main monetary policy instruments.¹⁹⁶ Following the Resolution, the 1995 Central Banking Law¹⁹⁷ provided the PBOC with market-oriented mechanisms, such as deposit reserve requirements, fixed base interest rates, rediscounting windows, central bank's credit to commercial banks, and open market operation to imple-

status of banks and their role in the system of macro-economic control, and exercise proper control over the volume of credit funds supplied in accordance with sound policy relating to currency circulation.

Id.

187. For example, broad money maintained its rapid expansion in 1995 on the strength of rising foreign reserves and higher-than-expected growth in domestic credit, as state commercial banks found new ways to circumvent the credit plan. *WORLD BANK COUNTRY SURVEY*, *supra* note 125.

188. Before 1953, cash management was the centerpiece of monetary policy. See generally Dai Genyou, *A Review of PBOC's Monetary and Credit Policy*, 12 *CHINA FIN.* (Beijing) 27 (1999).

189. See, e.g., Fernando Montes-Negret, *China's Credit Plan: An Overview*, 11 *OXFORD REV. ECON. POL'Y* 25 (1995).

190. See Yi GANG, *MONEY, BANKING, AND FINANCIAL MARKETS IN CHINA* 27 (1994).

191. See State Council, Decisions of the State Council on the PBOC's Exclusive Role as Central Bank (Sept. 17, 1983) [hereinafter 1983 Decisions].

192. *Id.* art. 1.

193. Montes-Negret, *supra* note 189.

194. *Interim Regulations on Bank Administration*, *supra* note 112, art. 5.

195. State Council, Resolution on Financial Reform No. 91 (1993).

196. *Id.* § 1.

197. Law of the People's Republic of China on The People's Bank of China, art. 22 (Mar. 18, 1995) [hereinafter Central Banking Law].

ment monetary policy. Credit plans are not even listed as a specific monetary policy tool. The PBOC, however, is not completely prohibited from using direct instruments to implement monetary policy. Article 22 of the Central Banking Law provides that the PBOC, in addition to the listed indirect instruments, can apply other monetary policy instruments defined by the State Council. Actually, the credit plan continued its application after implementation of the Central Banking Law.¹⁹⁸ Besides, the central bank is still controlling commercial banks' deposit and lending interest rates.¹⁹⁹

2. Credit Plan

a. General Introduction

The financial system in China had implemented the "credit plan" format by 1998—the central bank regulated supply and allocation of credit through an annual credit plan.²⁰⁰ The credit plan governed each bank's credit volume directly (in the aggregate, by different types of lending, and sometimes by different sectors, subsectors, and even individual borrowers) and translated the government's investment plans into reality.²⁰¹

The PBOC implemented the credit plan by imposing individual credit ceilings on specialized banks, and, later on, other commercial banks and nonbank financial institutions. After formulating an annual credit plan,²⁰² the PBOC allocated credit ceilings to each state bank's head office and to the PBOC branches in Shanghai and Shenzhen. In turn, the banks allocated credit ceilings to their branches, with the exception of the branches in Shanghai and Shenzhen, which received their credit ceilings from the PBOC local branch. The allocation enabled the PBOC to derive ceilings for credit by region and by branch. These ceilings were afterwards monitored by the local PBOC branch and were binding on the overall operations of each bank and on their respective branch office. Swapping of credit ceilings by branches whose loan demands were below the ceiling was not permitted.²⁰³

Separate credit ceilings were set for different categories of bank credits. There were three categories of bank loans: working capital credits (up to one year), technical renovation or transformation credits (one to five years), and fixed capital construction loans (five to ten years). Each maturity category was further broken down into activities, subsectors, and major projects.²⁰⁴ Some flexibility was allowed: the specialized banks could reallocate their "quota" from fixed asset lending to working capital loans, for example, but could not do the reverse.

Credit plans have expanded application in an attempt to counter credit plan leakage. Credit plans originally did not apply to nonbank financial institutions. In 1988, there were great leakages from the credit plan, primarily through a rapid expansion of loans by nonbank financial intermediaries.²⁰⁵ As a result, inflation began to accelerate in 1988. The PBOC

198. *Financial System Reform to Move into New Stages*, *supra* note 136.

199. Central Banking Law, art. 5.

200. See, e.g., Joseph C.H. Chai, *Domestic Money and Banking Reform in China*, H.K. ECON. PAPERS No. 14, 37 (1981).

201. WORLD BANK COUNTRY SURVEY, *supra* note 125, at 28.

202. For a detailed description of the process to formulate an annual credit plan, see WORLD BANK, *supra* note 162, at 37–38; and Montes-Negret, *supra* note 189.

203. WORLD BANK, *supra* note 162, at 38.

204. Working capital loans, for example, are subcategorized as loans for the construction industry, industry and commerce, technological development, local suppliers of equipment and inputs, special purposes, housing, bridges, and capital construction reserve fund. Montes-Negret, *supra* note 189.

205. See LARDY, *supra* note 20, at 137.

had to institute a broader credit plan beginning in March 1989.²⁰⁶ Under the credit plan in the broader sense, all lending institutions, including credit cooperatives, trust and investment companies, and other nonbank financial intermediaries, were subject to credit ceilings.²⁰⁷

b. The Relaxation of Credit Plan

The economic reform in China has been observing the gradual relaxation of credit plans. The traditional distinction between budget funds for financing enterprise fixed capital and quota working capital, and bank credits for financing enterprise above-quota working capital was abandoned shortly after the initiation of the economic reform. Credits were increasingly used to finance not only enterprise above-quota working capital but also quota working capital and fixed capital requirements.²⁰⁸

From the mid-1980s, efforts were made to eliminate overall direct credit controls on bank lending. For many years before 1985, banks submitted deposits to their headquarters, received targets for loan making, and requested funds when they needed them.²⁰⁹ This strict management of the credit fund guaranteed the full implementation of the credit plan. Since 1985, the central bank began to adopt a method of dividing funds among specialized banks and linking the amount of loans made by them to their deposits. The central bank was no longer the only supplier of funds to specialized banks, which could borrow in financial markets as well.²¹⁰ As a result, though credit ceilings continued to be assigned to specialized banks in accordance with the annual credit plan,²¹¹ they were virtually no longer mandatory.²¹² Although the direct credit control was reintroduced in the late 1980s as inflationary pressures mounted, the state commercial banks already possessed some autonomy in extending working capital loans, which accounted for 60 percent of the credit plan.²¹³

A new round of financial reform started in 1993.²¹⁴ The establishment of the three policy banks and the adoption of the Central Banking Law and Commercial Banking Law increased the autonomy of state commercial banks in lending decisions. Although the credit plan was strictly enforced in 1994 and 1995, state commercial banks were granted increasing autonomy in making investment-lending decisions within their individual credit ceilings and were gaining some independence to pursue commercial objectives.

In 1994, the PBOC issued new prudential ratios in pilot form to guide the operations of

206. WORLD BANK, *supra* note 162, at 32.

207. *Id.* at 31.

208. See generally State Council, Circular of the State Council Approving the Report of the People's Bank of China on PBOC's Mono-Management of State-Operated Enterprises' Working Capital (June 25, 1983); and State Council, Report of the PBOC Concerning the Division of Business Scope in Fixed Asset Loans Among Specialized Banks (May 13, 1984).

209. 1983 Decisions, *supra* note 191, art. 3. This article confirmed the system.

210. See, e.g., Gengyou Dai, *A Review of PBOC's Monetary and Credit Policy*, 12 CHINA FIN. (Beijing) 27 (1999).

211. *Interim Regulations on Bank Administration*, *supra* note 112, art. 35.

212. 1983 Decisions, *supra* note 191, art. 3. This article confirmed the system.

213. The banks' freedom to allocate investment loans, however, was still circumscribed by a detailed lending program drawn up by the State Planning Commission in consultation with the central bank, the MOF, and the SETC. WORLD BANK COUNTRY SURVEY, *supra* note 125, at 27.

214. In November 1993, the Third Plenum of the Fourteenth National Congress of the CCP set the future course of financial sector development in China. See generally *Decisions on Issues Concerning the Establishment of the Socialist Market Economy System*, XINHUA MONTHLY (Beijing), Nov. 1993, at 6.

banks and nonbank financial institutions,²¹⁵ requiring banks to keep their loan–deposit ratio below 75 percent.²¹⁶ The new ratios were introduced to complement the credit plan. Credit ceilings, however, still applied to banks whose lending volume exceeded the prescribed loan–deposit ratio and to banks that did not have stable deposit resources.²¹⁷ The 1995 Commercial Banking Law legitimized asset-liability management ratios.²¹⁸ In 1997, the application of the credit plan was limited to the big four and the three policy banks.²¹⁹ On December 24, 1997, the PBOC issued a Circular announcing the abolition of the ceiling control on state commercial banks' loan sizes on January 1, 1998.²²⁰

c. Negative Effects of the Credit Plan

Under the credit plan, banks were actually facing a captive market, where they had no choice but to lend to designated borrowers. For example, under the credit ceilings set in the early 1990s for the largest specialized bank, the ICBC, about a third of lending went to mandatory loans for key economic sectors, another third went to fixed-asset loans, and another 10 percent was committed to specific projects of local governments. Thus, less than 20 percent of the bank's lending was decided autonomously. The achievement of investment targets by the government has come at the cost of deteriorating loan portfolios in the banks. Although the credit planning system was removed, the negative influences of this system will remain with China's banking system for a long time.

Under the credit planning system, banks acted largely as passive channels, allocating credit to priority sectors, subsectors, and projects selected by national and local governments. This resulted in weak internal controls, especially risk-management ability. Credit plans seriously weakened the banks' awareness and effective control of credit risks. As passive financial agencies of the government, they did not need to manage their risks.²²¹ The lack of risk-management ability was evident in the sharp reduction in new loans in the first quarter of 1998. When the credit ceilings on banks were removed in 1998, banks were forced to cut their lending because they could not evaluate the risk of some projects properly.²²²

215. See *Circular of the PBOC Concerning the Asset-Liability Management of Commercial Banks* [zhongguo renmin yinhang guanyu dui shangye yinhang shixing zichan fuzhai bili guanli de tongzhi] (Feb. 15, 1994) [hereinafter *Asset-Liability Management Circular*].

216. See generally *id.*, appendix; and Montes-Negret, *supra* note 189, box 2.

217. *Asset-Liability Management Circular*, *supra* note 215, art. 6.

218. Commercial Banking Law, art. 39.

219. See Editorial Comment, *A Major Reform to Macro Financial Regulation and Control* [jingrong hongguang tiaokong de zhongdagaige], PEOPLE'S DAILY, Dec. 26, 1997. The three policy banks are still subject to credit ceiling control. See PBOC, Circular on Improving the Loan Size Management for State Commercial Banks [zhongguo renmin yinhang guanyu gaijing guoyou shangye yinhang daikuan guimo guili de tongzhi] (Dec. 24, 1997) [hereinafter *Loan Size Management Circular*].

220. *Loan Size Management Circular*, *supra* note 219.

221. This happened in South Korea as well. In South Korea, beginning in the early 1980s, government involvement in bank lending decisions was gradually reduced, but banks developed few skills in credit analysis or risk management and lending decisions were still largely based on the availability of collateral rather than on an assessment of risk and future repayment capacity. Balino, *supra* note 63, at 20.

222. See, e.g., *A Survey on the Loan Extending Behavior of Chinese Commercial Banks*, 9 CHINA FIN. (Beijing) 27 (1998).

3. Interest Rate Control

a. The Development of Interest Rate Control

Interest rate control has been a dominant feature of China's financial system. Before the economic reform, bank interest rates in China remained at low levels with very few brackets and were always fixed for long periods of time.²²³

Since reform began, however, interest rate policy has gone through adjustments that have enabled interest rates to function as a lever in regulating the supply and demand for funds.²²⁴ Interest rates continued to be set administratively by the PBOC, subject, however, to the approval of the State Council. The 1986 Interim Regulations on Bank Administration provide, except for interbank lending interest rates,²²⁵ the interest rates should be set by PBOC headquarters.²²⁶ In December 1990, the PBOC promulgated Interim Provisions on Interest Rate Administration, providing procedures for the PBOC to fix and administrate RMB interest rates.²²⁷ The 1995 Commercial Banking Law, which provides that a commercial bank shall operate and assume civil responsibilities independently,²²⁸ confirms that the commercial banks shall fix their interest rates for deposits and loans pursuant to the ceiling and floor interest rates defined by the PBOC.²²⁹ On March 2, 1999, the PBOC issued its new Provisions on RMB Interest Rate Administration.²³⁰ These Provisions grant financial institutions more freedom in deciding interest rates; the deposit and lending rates, however, are still fixed by the PBOC.²³¹

b. The Negative Effects of Interest Rate Control

Among all administrative restrictions, interest rate control does the greatest harm to the functioning of market discipline. With interest rates being set administratively by the PBOC, sometimes at a much lower level to subsidize the development of certain priority industries or loss-making enterprises,²³² commercial banks have no way to discipline unsustainable borrowers by interest rates. Actually, even under the floating rate system, banks are not allowed to raise their lending rates when they lend to large SOEs. In the September 1999 widening of rate floating for lending to small- and medium-sized enterprises, the PBOC clearly stated that lending rates for loans to the 512 key SOEs should not be floated upward.²³³

To make matters worse, interest rates in China have never been determined according to the price level and the supply and demand of funds. Many characteristics reflected in the

223. See Hongru, *supra* note 70.

224. See *id.*

225. *Interim Regulations on Bank Administration*, *supra* note 112, art. 45. The article authorizes state specialized banks to decide the interbank lending interest rates.

226. *Id.* art. 42.

227. PBOC, Interim Provisions on Interest Rate Administration [lilv guanli zhanxing guiding] (Dec. 1990).

228. Commercial Banking Law, art. 4.

229. *Id.* art. 31.

230. PBOC, Provisions on RMB Interest Rate Administration [renminbi lilv guanli guiding] (Mar. 2, 1999) [hereinafter 1999 Interest Rate Provisions].

231. *Id.* arts. 5-6.

232. There were more than thirty preferential rates around 1995. See, e.g., INTEREST RATE LIBERALIZATION AND MONEY MARKET DEVELOPMENT 19 (Mehran et al. eds., 1996).

233. See Zhou Rongfan & Chao Deyun, *The Reform and Development of China's Floating Interest Rate System* [woguo fudong lilv zhidu de gaige he fazhan], 10 CHINA FIN. 23, 24 (1998). The PBOC also excluded individual housing loans, preferential loans, and loans from policy banks from the application of floating interest rates.

structure of interest rates in other countries—differentials for risk, maturity, inflationary expectations, and the opportunity costs of alternative investments—are not yet fully reflected in China's rate structure. Rather, interest rates are determined according to a combination of price levels, the cost for banks to absorb funds, and the bearing capacity of enterprises. According to a 1996 World Bank report, China's interest rate policy "fulfills a complex set of objectives, reflecting the authorities' 'revealed preferences' with respect to distribution of subsidies to various productive activities, groups and regions; policies for industrial and agricultural development; and resource transfer from depositors to the state or other borrowers."²³⁴

Further, because of the government's intention to use higher interest rates to mobilize savings while at the same time providing cheap credit to enterprises, the interest margin received by China's commercial banks is narrow and sometimes even negative.²³⁵ The margin between one-year working capital loans and one-year household deposits has systematically declined since 1982. Consequently, even according to official statistics, the rate of return on bank assets has been falling and turned negative for the first time in 1996. This deterioration occurred despite the fact that many banks treat accrued (but often unpaid) interest as paid income, make negligible provisions for bad debt (based on instructions from the MOF), and raise earnings through various unofficial add-on fees and service charges. Over time, the result has been a steady de-capitalization of the banks.²³⁶ The government continues its policy to sacrifice the banks for economic growth. This is evidenced in the seven consecutive interest rate cuts from May 1996 to July 1999, and also by the limited application of floatable interest rates. To stimulate economic growth, interest rates were consecutively cut seven times from May 1996 to July 1999 (see Table 4). These seven consecutive interest rate cuts reduced interest rate margins of Chinese banks by 0.9 percent.²³⁷

c. The Prospectus of Liberalizing Interest Rates in China

Chinese authorities are determined to liberalize RMB interest rates. As early as 1993, a limited scope for interest rate administration system reform was defined.²³⁸ The State Council's Resolution on Financial Reform in 1993 called for a reform of interest rate policies and vested the power to formulate policy decisions in the PBOC under the leadership of the State Council.²³⁹ The PBOC, accordingly, formulated a plan to liberalize interest rates

234. WORLD BANK COUNTRY SURVEY, *supra* note 125, at 24.

235. See, e.g., *China's Central Banker Talks up Bank, Interest Rate Reform*, Oct. 12, 1999, at <http://www.chinaonline.com>.

236. See, e.g., World Bank, *supra* note 44.

237. Dai Xianglong, *Improve Financial Services to Assist Reform and Progress of SOEs in Accordance with the Guideline of 4th Plenary of the 15th Central Committee of CPC*, 11 CHINA FIN. 4, 5 (Nov. 1999).

238. *Decisions on Issues Concerning the Establishment of the Socialist Market Economy System*, *supra* note 214. It was stated that the central bank should adjust the basic interest rate in a timely fashion according to the demand and supply of funds in the market, and allow the deposit and lending rates of commercial banks to float within a limited margin. *Id.*

239. See State Council, Resolution of State Council on Financial System Reform No. 91, § 4 (1993) [hereinafter Resolution on Financial System Reform]. It is stipulated that the PBOC should set a ceiling for deposit rates and a floor for lending rates; streamline the relationship of deposit rates, lending rates, and interest rates for securities; set different interest rates according to maturity, cost, and risk, and maintain reasonable differentials between these rates; and try to establish a market-oriented interest rate system based on the central bank rate. *Id.*

Table 4 The Seven Interest Rate Cuts from May 1996 to July 1999 (Annual Interest Rates in Percentage Form)									
	1/5/96	23/8/96	23/10/97	25/3/98	1/7/98	7/12/98	10/6/99		
Average Reduction in Deposit and Saving Interest Rates	0.98	1.5	1.1	0.16	0.49	0.50	1.0		
Average Reduction in Lending Interest Rates	0.75	1.2	1.5	0.6	1.12	0.5	0.75		
Impacts on Banks	N.B.*	N.B.	R.M.**	R.M.	R.M.	R.M.	I.M.***		
Impacts on Enterprises	B.****	B.	B.	B.	B.	B.	B.		

* N.B.: Banks did not benefit from the reduction.

** R.M.: Reduced interest rate margin.

*** I.M.: Increased interest rate margin.

**** B.: Enterprises benefited from the reduction in lending interest rates.

Source: Zhou Rongfang, *Rate Cut by PBOC Aimed at Stimulating Domestic Demand* [yinhang zhaibei jiangxi, jishi kuodai neire], 7 CHINA FIN., July 1999, at 8.

in three stages,²⁴⁰ with the interbank market rate liberalization as the first stage, followed by the lending rate liberalization, and finally deposit rate liberalization.²⁴¹

Progress has been made in this area. Since June 1, 1996, ceilings on interbank lending interest rates have been abolished.²⁴² With the establishment and improvement of floating rate systems, financial institutions can now charge different interest rates on the basis of their borrowers' creditworthiness within the floating scope.²⁴³ Since September 21, 2000, financial institutions are allowed to set their foreign currency lending rates in line with the international market; rates on foreign currency deposits of more than \$3 million are also liberalized.²⁴⁴ The liberalization of interest rates, however, so far has not touched the foundation of the interest rate control system in China. Commercial banks in China must set their RMB deposit and lending rates pursuant to the ceiling and floor interest rates defined by the PBOC.²⁴⁵ Moreover, except for short-term loans, banks and other financial institutions are not even allowed to decide how interest shall be calculated, paid, or collected.²⁴⁶

There is still a long way to go before interest rate control can be completely abolished. A World Bank survey lists five preconditions for successful interest rate liberalization, that is a financially sound real sector (in China, mainly SOEs); banks with positive net worth; bank management with high quality, regulatory, and supervisory standards; and a gradual process.²⁴⁷ While China has made considerable progress in all these areas, the weak financial health of segments of the state enterprise sector and the deteriorating quality of banks' assets, however, suggest that interest liberalization cannot be achieved in China quickly.²⁴⁸

D. WEAK INTERNAL CONTROL SYSTEMS WITHIN STATE COMMERCIAL BANKS

1. *The Importance of Internal Controls*

Internal controls are systems established to provide reasonable assurance of effective and efficient operations, reliable financial information and reporting, and compliance with laws and regulations.²⁴⁹ A bank's internal controls can ensure capital adequacy and minimize market, transfer, and credit risk, and, by extension, secure the health of a banking system.

The importance of internal systems has been widely recognized, especially after the textbook case of the Bank of Credit and Commerce International collapse.²⁵⁰ William J.

240. See generally Ping Xie, *Toward a Market-Oriented Interest Rate Policy in the Transformation of China's Economy*, in INTEREST RATE LIBERALIZATION AND MONEY MARKET DEVELOPMENT, *supra* note 232, at 19.

241. It is important to put deposit interest rates liberalization after the lending rates liberalization. Without a prior or simultaneous freeing of lending rates, freeing deposit rates would result in a substantial squeeze on bank margins, drastically reducing their already low level of profits.

242. Dai, *supra* note 210.

243. See Dai Xianglong: *China to Adopt Market Interest Rates*, Jan. 24, 2000, at <http://www.chinaonline.com>.

244. See, e.g., James Kynge, *Beijing Move on Foreign Currency*, FIN. TIMES (London), Sept. 5, 2000.

245. Commercial Banking Law, arts. 31, 38.

246. For details of how interests should be calculated, paid, or collected, see 1999 Interest Rate Provisions, *supra* note 230, arts. 11–29.

247. WORLD BANK COUNTRY SURVEY, *supra* note 125, box 3.1.

248. Dai Xianglong was reported to predict a three-year period for decontrolling interest rate. He said the main reason for the caution is that poor asset quality of China's four largest state banks could put them at disadvantage in competing with smaller but more efficient private banks. See James Kynge, *China to Liberalize Rates Regime within Three Years*, FIN. TIMES (London), July 19, 2000.

249. See, e.g., INTERNAL CONTROLS IN BANKING 1 (Ray Kinsella ed., 1995).

250. It is concluded that the BCCI collapse shows how, in the absence of effective internal controls and a compliance "culture," fraud and dissimulation will inevitably flourish. See, e.g., John F. Mogg, *Internal Controls: The EC Response to BCCI*, in INTERNAL CONTROLS IN BANKING, *supra* note 249.

McDonough, Chairman of the Basle Committee and President of the Federal Reserve Bank of New York, stated that "the Basle committee has been focusing on ways of strengthening internal controls at banks in recognition of the fact that internal control deficiencies continue to be a source of major problems and significant losses for banks globally."²⁵¹

2. *Weak Internal Controls of China's State Banks*

Banks under heavy administrative controls often do not have the opportunity to develop their risk-management capacities. In Japan, for example, tight controls of bank behavior by regulators had long been a substitute for risk management by banks themselves and for monitoring by shareholders and depositors. When the controls were successively relaxed in the 1970s and 1980s, a vacuum emerged in bank risk management.²⁵² This might have been a factor behind massive lending into real estate-related activities of Japanese banks in the 1980s, where credit analysis was just a matter of estimating the future path of real estate prices.²⁵³ This is the case for Chinese banks (especially state commercial banks) as well. After decades of extending loans largely at the behest of political leaders, the banks have not accumulated sufficient experience in real commercial banking.²⁵⁴

According to a 1996 World Bank report about China, China's state commercial banks are handicapped by such operational deficiencies as the absence of key management processes (planning, budgeting, reporting); lack of familiarity with asset and liability management techniques; inadequate accounting standards that render performance and risk assessment difficult; substandard information systems; inappropriate internal incentives systems for staff; and poorly articulated institutional structures and legal frameworks.²⁵⁵ These are needed to underpin a sound system of corporate governance, eliminate interference and conflicts of interest, increase management autonomy, and protect the interests of owners and depositors.

These weak internal controls led to the accumulation of NPLs.²⁵⁶ The PBOC launched an inspection at the end of 1998 into fifty branches of state banks where there had been sharp increases in bad debts and found serious problems including: " 'chaotic' internal management, 'blind lending', falsifying [NPL] data, severe dereliction of duty and 'fraud for self-interest.' "²⁵⁷ More seriously, weak internal control systems have led to numerous instances of corruption and fraud by bank officials,²⁵⁸ as well as misdemeanors by bank man-

251. Press Release, Basle Committee, The Basle Committee Issues a Framework for Internal Control Systems in Banking Organization (Sept. 22, 1998), available at <http://www.bis.org/press/p980922a.htm>.

252. Even as of 1996, banks were reluctant to go ahead with self-assessment of their loan portfolio because, in their view, this would involve much preparation on their part. See Kazuo Ueda, *The Japanese Banking Crisis in the 1990s*, in STRENGTHENING THE BANKING SYSTEM IN CHINA: ISSUES AND EXPERIENCE 251, 259 n.7 (BIS Policy Papers No. 7, Oct. 1999).

253. *Id.* at 256.

254. A senior partner at PriceWaterhouse was reported as saying: "China's bankers are still ill-equipped to evaluate the quality of new loans." *Long and Slow Road Ahead for Banking System Reform*, H.K. STANDARD, Jan. 31, 1997.

255. WORLD BANK COUNTRY SURVEY, *supra* note 125, at 34-35.

256. See, e.g., Zhaoxing Wang, *Financial Supervision: Opportunities and Challenge* [jinrong jianguan: fanzhang yu tiaozhan], 12 CHINA FIN. 18 (Dec. 1999); and Shusheng Kang, *Commercial Banks' Internal Controls: Borrowing and Innovation* [shangye yinhang neikong zhidu: jiejian yu chuanguxing], 3 (1999).

257. *China Pledges Tough Measures to Combat NPLs—Report*, DOW JONES INT'L NEWS, Mar. 19, 1999; James Harding, *China Banks Sack Managers*, FIN. TIMES (London), Mar. 20, 1999.

258. See, e.g., James Harding, *Officials Arrested over Chinese Fraud Scandal*, FIN. TIMES (London), Mar. 5, 1999, at Asia-Pac. 5; and *China: Corruption May Threaten State*, FIN. TIMES (London), Mar. 5, 1999.

agers.²⁵⁹ A survey conducted at the end of 1998 divided the loan assets in one of the big four into loans under credit plans or government instruction and loans granted at the full discretion of the bank. It discovered that more NPLs were created via lending at the full discretion of the bank, both in absolute amount and in proportion to the whole loans, than were created via lending under credit plans or government instructions.²⁶⁰

China's state commercial banks are striving to improve their internal control systems. To enhance internal controls within China's financial institutions, the PBOC issued Guidelines for Enhancing Internal Controls of Financial Institutions.²⁶¹ The Guidelines consist of thirty-two articles in six chapters, covering internal controls of commercial banks and nonbank financial institutions.²⁶² Chinese banks are establishing and improving their internal controls in the light of the PBOC Guidelines.

The improvement of internal management systems, however, cannot be finished overnight. Acquiring expertise and accumulating necessary data take time. Under the Commercial Banking Law, a commercial bank must make a strict examination of the borrower regarding its borrowing purpose and its ability and method of repayment.²⁶³ State commercial banks, however, need to develop their risk-management capacity before they can really do such examination. Currently, because banks do not have sufficient data and expertise to examine the creditworthiness of their borrowers and the proposed projects, they just simply take security for loans as required by the Commercial Banking Law without examining the repayment capability of the guarantor, the ownership and value of the mortgaged or pledged asset, and the feasibility of realizing the mortgage or pledge.²⁶⁴ That is one of the reasons why most of the loans went to SOEs, because many SOEs, though they might have bad cash flow, have extensive assets and can always come up with collateral for loans.²⁶⁵ This kind of asset-driven lending has led to the accumulation of NPLs and reflects the weak risk management capacity of China's state commercial banks.

E. INAPPROPRIATE BANKING REGULATION SUPERVISION

External regulation, especially prudential regulation and supervision, is critical to ensure the safety and soundness of individual banks and the whole banking system. The failure of prudential regulation and supervision will foster irregularities and over-risk-taking by banks. The failure of the PBOC to develop a prudential supervisory regime has been widely recognized as one of the causes of accumulation of NPLs on state commercial banks' balance sheets.²⁶⁶

259. See James Kyngé, *Report Reveals Banking Abuses*, FIN. TIMES (London), Dec. 17, 1999, at Asia-Pac. 9; and *China Auditor Uncovers Irregularities at Two State Banks*, DOW JONES INT'L NEWS, Dec. 16, 1999.

260. See, e.g., Haining Zhang & Haijie Ouyan, *How Can State Commercial Banks Prevent Credit Risks* [guoyou shangye yinhang fangfan xingdai fenxiang de chulu zai nali?], 10 CHINA FIN. (Beijing) 34, 34 (1999).

261. PBOC, Guidelines of the PBOC for Enhancing Internal Controls of Financial Institutions [zhongguo renmin yinhang jiaqiang jinrong jiguo neibu kongzhi de zhidao yuanze] (May 16, 1997) [hereinafter Internal Control Guidelines].

262. *Id.* art. 4.

263. Commercial Banking Law, art. 35.

264. *Id.* art. 36. This article requires that, except for loans to borrowers with high credit ratings and capability of repayment, a commercial bank shall extend a loan against a security, and conduct strict examination of the repaying capability of the guarantor, the ownership and value of the mortgaged or pledged asset, and the feasibility of the realization of the mortgage or pledge. See also General Lending Rules, *supra* note 134, art. 10.

265. See, e.g., Anthony Neoh, *Rethink Asia: Reality Check*, FAR E. ECON. REV., May 6, 1999, at 46.

266. Wang, *supra* note 256.

The PBOC in China, involved in formulating and enforcing credit plans for such a long time, shifted to the prudential regime just a few years ago.²⁶⁷ Besides, the government's interference in credit allocation not only circumvented the need for thorough risk assessment by the banks, made the government co-responsible for the quality of banks' assets, and provided an implicit government guarantee on banks' liabilities, but also constrained the supervisors in their ability to penalize banks for making bad lending decisions. Thus, although bank supervision activities in China date from May 1985, when PBOC established its department of bank supervision and examination,²⁶⁸ the PBOC failed to develop prudential supervision on banks until the mid-1990s.²⁶⁹

The 1995 Central Banking Law authorized PBOC to exercise supervision and control over the financial industry²⁷⁰ and clarified the PBOC's supervisory scope.²⁷¹ The PBOC's role in regulating and supervising the financial industry was later redefined by the State Council. The regulation and supervision of securities businesses and insurance companies was taken from the PBOC in 1998 with State Council's decision to make the CSRC the sole organization to supervise the country's securities industry,²⁷² and the establishment of the China Insurance Regulatory Commission (CIRC).²⁷³ As a result, the current financial regulations and supervision are carried out by three agencies under the State Council: the PBOC,²⁷⁴ CSRC, and CIRC carry out their respective regulatory and supervisory respon-

267. As recognized by many Chinese commentators, the prudential regime and the credit plan are a mismatch in both theory and practice. See, e.g., CHINESE FINANCIAL SYSTEM REFORM 31–38 (Chen Yuan ed., 1994); and Weihong Jin, *An Empirical Study of Debt-Capital Ratio Management as Introduced by China's Specialized Banks*, 3 GUANLI SHIJI 44 (1996).

268. This department, known as the Examination and Supervision Department, had more than 4,700 personnel by the end of 1988. Among them, however, only about 200 were at the level of senior economist or senior accountant with slightly more than 1,200 in the middle grades. WORLD BANK, *supra* note 162, at 33.

269. Prior to 1995, the PBOC mainly focused on licensing and authorization. Wang, *supra* note 256, at 16.

270. Central Banking Law, art. 2.

271. *Id.* arts. 30–36.

272. The CSRC began in 1992 as the executive branch of the State Council Securities Commission, which supervised the securities market. In 1997, the CSRC was charged with supervising the Shanghai and Shenzhen stock exchanges. In 1998, as part of the government's effort to streamline the bureaucracy, the SCSC and the CSRC were merged as CSRC. According to a decision of the State Council in October 1998, the new CSRC enjoys ministerial rank and performs as the sole regulatory agency for the securities industry in China, responsible for overseeing securities brokerages, which were formerly supervised by the PBOC; directly administering all local securities supervisory bodies, which used to be under local governments; and undertaking the responsibilities of the SCSC. The new commission also regulates all international participation in China's burgeoning securities sector. *China Approves Regulatory Body for Securities Sector*, Oct. 20, 1998, at <http://www.chinaonline.com>.

273. On November 18, 1998, China formally established an insurance regulatory body, the China Insurance Regulatory Commission (CIRC). The insurance industry was previously supervised by the PBOC. The newly established CIRC is subject directly to the State Council and fully authorized to regulate and supervise China's insurance industry. Its responsibility includes the drafting and adoption of policies, regulations, and rules about commercial insurance; supervising insurance enterprises to ensure that they carry their businesses in accordance with the law and regulation; fostering fair competition between insurance enterprises; promoting insurance risk assessing and early warning systems, etc. See Tian Li, *The CIRC Was Established in Beijing Today* [*Zhongguo Baoxian Jiandu Weiyuanhui Zai Jing Chengli*], PEOPLE'S DAILY (Overseas Ed.), Nov. 19, 1999, at 1.

274. In October 1999, what under the PBOC supervision was three policy banks, the big four, nine joint stock commercial banks, eighty-eight city commercial banks, more than 50,000 rural credit cooperatives, about 3,100 urban credit cooperatives, nonbank financial institutions, and foreign-invested financial institutions not under the supervision of CSRC or CIRC. See Baoqing Wang, *The Enhancing Financial Supervision and Administration in China* [*changyin zaishou- woguo jinrong jianguan buduan jiaqiang*], JINRONG SHIBAO, Oct. 10, 1999, at 1.

sibilities in the banking, securities, and insurance industries. The division of duties among these agencies allows the PBOC to concentrate on banking regulation.

So far, the PBOC is implementing its prudential supervision over commercial banks on the following three fronts.²⁷⁵ First, capital adequacy and asset-liability ratio supervision was implemented. In 1994, the PBOC issued a set of new prudential ratios in pilot form to guide the operations of banks and nonbank financial institutions.²⁷⁶ The 1995 Commercial Banking Law legitimized the asset-liability management ratios requirements.²⁷⁷ On December 12, 1996, the PBOC issued Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks,²⁷⁸ further detailing the ratios set by the Commercial Banking Law, and added new ratio management requirements, covering market risk and off-balance sheet items. Second, supervision of asset quality, liquidity, and profitability was implemented. The PBOC has designed a set of indicators to monitor the asset quality, liquidity, and profitability of commercial banks.²⁷⁹ Since 1998, a five-level loan classification system based on risk-management has been introduced.²⁸⁰ Third, a policy of promoting internal controls within commercial banks has been implemented. As mentioned above, the PBOC issued Guidelines on Enhancing Internal Controls of Financial Institutions in 1997, requiring commercial banks to improve their internal control systems in accordance with the guidelines.

The prudential regulation and supervision of the PBOC on commercial banks, however, is at a very early stage. So far, the PBOC relies heavily on punishing irregularities after the fact rather than prevention.²⁸¹

F. SUMMARY

All the problems pointed out above have a negative impact upon the conditions of market discipline for banks and SOEs. The empirical analyses support the conclusion of the theoretical framework section, that is, the deterioration of conditions for market discipline is the ultimate cause of bank NPL problems in China. Because market discipline cannot really work on banks (especially state commercial banks) and SOEs, budget constraints no longer bite, which results in unsustainable borrowing by SOEs and continuous creation of NPLs by banks.

1. *The Captive Financial Markets*

The financial markets in China are extremely captive rather than open and competitive. Households and enterprises do not have many alternatives but to deposit or save their extra money with state banks.

Banks are facing a captive market as well. Massive administrative controls on banks actually have deprived banks of the freedom to make lending decisions on commercial stan-

275. Liu, *supra* note 249.

276. Asset-Liability Management Circular, *supra* note 215.

277. Commercial Banking Law, art. 39.

278. PBOC, Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks [shangye yinhang zhichan fuzhai bili guanli jiankong, jianche zhibiao] (Dec. 12, 1996).

279. *Id.*

280. Kyng, *supra* note 136.

281. It is reported that China's financial authorities have fired bank managers and revoked Communist Party membership of some officials who were not controlling or were trying to cover up rising levels of NPLs. *China Pledges Tough Measures to Combat NPLs—Report*, *supra* note 257; and Harding, *supra* note 257.

dards. State banks had very limited freedom in deciding to whom they lend under the credit plan (credit ceiling). Although the credit ceiling has been removed since 1998, state commercial banks are still forced to lend to unbankable projects and loss-making SOEs in the name of policy loans.

2. *The Information Problem*

The information problem is not exclusive to the socialist economy. This problem, however, bears unique features in socialist economies: the main difference between the socialist and capitalist economies on the issue of information is not accuracy or comprehensiveness of the information, but the utilization of the information. In capitalist economies, the information is utilized in a decentralized way. Those using the information feel the benefits of it directly. Under socialist economies before reform, attempts were made to centralize crumbs of knowledge and information that had been scattered in all directions, and if the information in the subordinate's possession had to be "passed up the ladder," it might not be in his interest to transmit it, and he might fail to do so out of laziness; or it might be fully in his interest to pass it up in a distorted form. This explains why the information problem is more serious in formerly planned economies.²⁸²

The lack of incentives to use information survives the economic reform. Enterprises, especially SOEs, knowing that banks will sooner or later lend to them under a credit plan, have no incentive to produce favorable information about their financial situation, let alone unfavorable information. Banks, aware that they have to lend to certain enterprises or projects under the credit plan, do not have incentives to evaluate borrowers' creditworthiness and monitor borrowers' cash flow. Besides, the inappropriate prudential regulation is not enough of an external check that banks examine their borrowers' creditworthiness properly.

In addition to the incentive problem, the veracity of the information also poses a serious problem. The underdeveloped accounting rules and disclosure practices have impeded banks from obtaining reliable information about their borrowers.²⁸³ Actually, even if they obtained the relevant information, their immature internal controls and risk-management ability are still obstacles for them to evaluate the financial situation of their borrowers properly.

3. *The Bailout Expectation*

The implicit and explicit government guarantees—soft budget constraints in China—encourage banks and SOEs to resort to government bailout whenever they encounter difficulties. The economic reform has substantially reduced budget subsidies, soft tax, and price subsidies on SOEs; the soft budget constraints, however, are far from having been eradicated. Rather, they are now mainly in the form of soft credit from banks. Banks are still lending to loss-making SOEs under formal or informal government intervention.

4. *The Irresponsibility to Market Signals by Borrowers*

Borrowers' ignorance of market signals can be traced to soft budget constraints. The soft budget constraints render the firm's interest in cost and profit very weak. Actually, even if

282. See KORNAI, *supra* note 47, at 129–30.

283. A random state audit of 100 SOEs in China found that eighty-one of the companies reported false assets worth RMB 3.8 billion and eighty-nine SOEs reported false profits worth RMB 2.7 billion in 1999. To make matters worse, previous audits of the 100 SOEs by eighty-two public auditing firms found nothing awry with the accounts of sixty-two of the firms, which seriously undermines confidence in public auditors. See *Random Audit Exposes Accounting Fraud in Most Chinese SOEs*, Dec. 27, 1999, at <http://www.chinaonline.com>.

the borrowers have the incentives to respond to interest rate signals, the interest rates in China are not signaling properly. The real interest rate in China is persistently and purposely negative, and the banks are not allowed to adjust the interest rates freely. Where the real interest rate is negative, anyone who takes up a loan from the bank can pocket a small donation from the bank. Every practical argument speaks in favor of getting as deeply in debt as possible.

V. Policy Recommendations

China's NPL problem is not limited to individual banks; rather, it is pervasive in all state commercial banks. NPLs not only have negative effects on state commercial banks, but also on the economic reform and real economic growth. And, because the number and amounts of NPLs are so huge, the big four have been technically insolvent for several years. Given their weight in the whole financial system, the NPL problem with state commercial banks is threatening the stability of the whole financial system, and even the whole economy.

The causes of NPLs with state commercial banks are also systematic. The state bank-dominated financial system, the bank-centric finance, the soft credit to SOEs in the form of policy loans, and administrative controls on banks have resulted in weak internal controls in banks and inappropriate prudential supervision on banks. In other words, China's NPL problem is actually a reflection of weaknesses in its financial and corporate sectors and requires a systematic solution.²⁸⁴

Based on the analyses of the seriousness of and causes of the Chinese commercial banks' NPL problem, the author would like to make the following policy recommendations.

A. THE NPL PROBLEM MUST BE SOLVED IMMEDIATELY

According to some observers, restructuring Chinese banks before the underlying causes of the accumulation of bad loans are removed would be close to useless. Restructuring SOEs—that is, reforming these firms and imposing upon them hard budget constraints—should be the first step. This, in turn, would require discharging SOEs from the responsibility of providing a broad range of social services, shifting such costs directly to the budget: the accompanying increase in public expenditure should be matched by a corresponding increase in tax revenues. At the present time, when the growth of the Chinese economy has slowed and public confidence in the economy, for a variety of reasons, is low, it is definitely not the right time for hastening real reform of the SOEs, and hence there should be no rush to undertake a radical reform of the Chinese financial sector.²⁸⁵ However, this should not be used as an excuse for doing nothing until an unlikely “Big Bang” turns the Chinese economy around.

First, as indicated before, NPLs accumulated in the books of the big four threaten the stability of China's financial system. Second, because of the bank-centric feature of China's

284. LARDY, *supra* note 20.

285. Lau, *supra* note 37, at 84. That author, after analyzing the fiscal situation of China (using indicators such as the size of the annual government total and current deficit, the public demand for public debt, the fiscal capacity for servicing the public debt, the lending and bond-buying capacity of the banking system, and public confidence in the banking system and the currency), concluded that the Chinese economy is not in imminent danger of financial collapse, despite the existence of a significant stock of NPLs. The system is sustainable for at least another decade or longer. *Id.* at 80–85.

financial system, it is widely recognized that if banks continue to be trapped with NPLs, they will not be able to finance economic growth. Last but not least, transparent accounting and clear assignment of responsibilities can be a powerful instrument for making sure that SOEs are eventually restructured. Banks with clean balance sheets will have more incentives to monitor and impose financial discipline on their borrowers. That is essential for SOE restructuring in China.

The Chinese government has tried to harden soft budget constraints on SOEs since the beginning of economic reform. The efforts of the government, however, have achieved little. In his opening speech of the annual session of the NPC in 1999, Zhu Rongji, China's premier minister, admitted that "financial discipline is lax and economic order is somewhat in disarray" and ordered local authorities and state banks to stop lending to all but a few industry projects: "[w]ith the exception of a number of projects designed to raise the technological level of production, upgrade products and manufacture marketable products, government at all levels should stop examining and approving industrial development projects and banks should stop granting loans to them."²⁸⁶ Without solving the NPL problem within state commercial banks, it is predictable that adverse selection of state bank managers will not be uncommon. Insolvent state commercial banks with large exposure to SOEs will have to lend to loss-making SOEs if they do not want to be pulled down by the collapse of their large borrowers. In other words, it is impossible to expect state commercial banks trapped with NPLs to exercise financial discipline on SOEs if NPLs cannot be removed from their balance sheets.

To solve the problem, four Asset Management Companies (AMCs) have been set up to take NPLs from the big four state commercial banks.²⁸⁷ By the end of June 2000, the four AMCs have taken over RMB 1.3 trillion (U.S.\$157 billion) from the big four.²⁸⁸ The removal of NPLs from the banks' books should at least, to some extent, release banks' NPL burden and solve the adverse selection problem.

B. ENTERPRISE DEBT RESTRUCTURING

The problem with banks and SOEs is so interwoven that it can only be solved together. Lardy contributes the declining profitability, the declining capital adequacy, and the increasing share of NPLs of the big four to the point that a large and growing share of SOEs are unable to service their borrowings.²⁸⁹ Thus, without SOE reform, the NPL problem will not be worked out.²⁹⁰

286. James Harding, *China Tackles Bad Management*, FIN. TIMES (London), Mar. 6, 1999.

287. China opened all four AMCs within a span of about six months. The Cinda AMC was set up to tackle the debts of the CCB in April 1999, and has already signed debt-equity deals with a number of SOEs. In October 1999, the Dongfang (Orient) AMC was started to handle the debt of the BOC, the China Great Wall AMC was set up to take on the bad debt of the Agricultural Bank of China (ABC), and China Huarong AMC was launched to clear the debt of the ICBC. See, e.g., *China's Fourth Asset Management Company Ready to Roll*, Oct. 20, 1999, at <http://www.chinaonline.com>.

288. See, e.g., *Conversion Diversion: No Timetable Set to Float Renminbi*, CHINA CENTRAL BANKER EXHIBITS, July 19, 2000, at <http://www.chinaonline.com>.

289. See LARDY, *supra* note 22, at 17-18.

290. It is commonly recognized that financial reform and SOEs reform in China must be harmonized. See, e.g., IMF, *World Economic Outlook, World Economic and Financial Survey* (May 1999); Moody's Investors Service, *Banking System Outlook: China*, 3 (Aug. 1999); and Zongyu Wen & Qingmin Zhao, *On Financial Reform and SOEs' Strategic Restructuring* [shenhua jinrong tizhi gaige yu guoyou qiye zhanlexing gaizhu], 12 CHINA FIN. 9, 9 (1999); and Yuan, *supra* note 267, at 19-20.

Authorities in China have recognized the importance of debt restructuring. Following the establishment of the four AMC's, the State Economic and Trade Commission announced the initiation of the debt-equity swap scheme on August 3, 1999.²⁹¹ The scheme authorized the four AMC's and the State Development Bank (SDB) to forgive debts owed by SOEs in exchange for equity stakes in the enterprises.²⁹² By January 24, 2000, seventy-eight enterprises had entered into debt-equity swap agreements or frame agreements²⁹³ with AMC's or the SDB for the swap debts worth RMB 112.2 billion.²⁹⁴

C. ENDEAVORS MUST BE TAKEN TO PREVENT THE CREATION OF NEW NPLS

The seriousness of the NPL problem with state banks is not limited to the massive existing NPLs on the banks' books. The continuous creation of new NPLs is complicating the problem. Endeavors must be taken to control the creation of new NPLs. To achieve this, state commercial banks must be freed from making policy loans, unnecessary administrative controls on state banks must be removed, prudential regulation and supervision must be strengthened, and efforts must be made to promote internal controls within state commercial banks, especially the risk-management ability. More importantly, to foster competitive and open financial markets, China should continue its financial liberalization.

D. ENHANCING MARKET DISCIPLINE SHOULD BE THE MAIN THEME IN NPL WORKOUT AND PREVENTION

The lack of market discipline underpins macro and micro reasons for the accumulation of, and the increase in, NPLs in China. Without the restoration of market discipline, the NPL problem cannot be solved.

Following this conclusion, the procedures designed to work out NPLs must be aimed at restoring market discipline in China rather than simply employing government bailout. Even if there has to be government bailout, a cutoff date must be set up so that banks will have to take full responsibility for NPLs occurring after that date.

Besides, although prudential regulation is an effective curb on the creation of new NPLs, the regulation and supervision of banks, however, should not suppress the function of market discipline. For the banking system as a whole, the big issue is to transform state deposit-taking institutions with government-driven lending practices into independent commercial banks. This is the only way we can stop the creation of new NPLs.

291. See generally Tao Guangxiong, *Focus of State-Owned Enterprise Reform: Converting Debts into Shares Helps Ease Difficulties in State-Owned Enterprise Reform*, WORLD NEWS CONNECTION, Sept. 18, 1999, available at 1999 WL 26443497.

292. See Xia Li, *The Scope and Preconditions for Candidate Enterprises for the Debt-Equity Swap Scheme* [shishi zhaizhuanggu qiye de fangwei yu tiaojian], JINGRONG SHIBAO, Sept. 15, 1999, at 12.

293. Often a more detailed agreement will be signed later based on the framework agreement. The Second Auto Group, for example, signed a framework debt-equity swap agreement with all four AMC's and the SDB on December 30, 1999; a detailed agreement was later signed in April 2000. See *China Second Auto Works to Swap Debt for Equity*, Jan. 3, 2000, at <http://www.chinaonline.com>.

294. See Lan Luo, *The Goal of SOEs Going out of Red in Three Years Is Expected to Be Achieved This Year* [Guoqi Sannina Taikun mubiao jinjiang ke ruqi shixian], PEOPLE'S DAILY (Overseas Ed.), Jan. 26, 2000, at 1.